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DEVELOPMENTS IN ACCOUNTING

BY

F. R. M. DE PAULA, O.B.E., F.C.A.

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TO

MY WIFE

FOREWORD

By Sir Clive L. Baillieu, K.B.E., C.M.G.

Mr. de Paula has long held an honoured place amongst the leaders of his profession.

He has devoted his life to raising accountancy standards, to simplifying the form and presentation of accounts, to establishing budgetary control and financial planning, to improving business organization and developing techniques to meet the growing scale and complexity of modern business.

He has brought to this task, not only great technical knowledge, but a sustained enthusiasm and a gift for lucid and clear exposition which enlivens even the most difficult of subjects.

His audience has embraced the best elements in the professional, academic and business worlds of our time and generation. As a teacher for over twenty years in his own profession, as professor of accountancy and business organization in the University of London, as Controller of Finance of a great manufacturing business, he has gradually evolved and applied in practice the basic principles which are recorded in this book.

He has been a real pioneer, blazing a trail which has led by stages to the recommendations of Mr. Justice Cohen's committee and to the recent passing of the new Companies Act.

I am deeply impressed by certain aspects of the life and teaching of Frederic de Paula:

> His grasp of principles and his insatiable quest for knowledge. For him there have been no National frontiers. He acknowledges, with gratitude, the debt he owes to the best thinking and practice in the U.S.A;
>
> The success with which his teaching and practice have been based on principles first worked out theoretically in the cloistered calm of his University days;
>
> The candour and forcefulness with which he examines the weaknesses of Industrial Organization and Accountancy Training.

From his unique experience he has formed the view that the accountancy profession and industry should follow the lead of the U.S.A. and study in common on a University basis their basic problems. Thus

ever since I have kept in the closest touch with all of these developments.

When I found myself occupying a University Chair and responsible for the teaching of business organization, in addition to accountancy, I was compelled to study the former subject. At that time, my practical experience, I must confess, was limited to that of a practising accountant. However, I had had experience in service administration in the 1914–18 war. Here again I turned to American literature and became very interested in the problems of management, particularly financial planning and control. Upon this academic study I based my teaching, and this I found to be of the greatest assistance to me when later I went into industry.

It occurred to me, therefore, that these leaves from a traveller's note-book might possibly be of interest to any accountants and others who may be bewildered by the profound changes in our professional outlook. They are submitted in their original form, and thus they record observations, experiences and conclusions as they occurred, and it will be seen that early conclusions, as the result of further experience, were sometimes altered, extended and developed. There is repetition in several papers when the same ground is recrossed, and I hope that readers will not find this tedious, but I thought it best to leave these notes in their original form.

The book is arranged in four sections. Section I covers the development of accounting principles. The issuing, by the Council of the Institute of Chartered Accountants in England and Wales, of its recommendations on accounting principles, was one of the most important events in the life of the Institute. These recommendations have had far-reaching effects and have clearly been widely adopted in the recent Companies Act. This represents the culmination of this movement which had been developing for many years.

Section II deals with various aspects of financial planning and control in industry. Chapters XI and XII were based upon my academic study of the problem, but the subsequent chapters, XIII to XVI, were prepared after I went into industry. It will thus be seen how the original ideas based upon theory were hammered out and shaped on the anvil of practical experience.

Section III covers miscellaneous matters, including education for the accountancy profession, a subject in which I have been keenly [illegible]sted for many years. I have not included papers I gave on

auditing, except chapters XIX and XX, the latter, perhaps, for reasons of sentiment as it was my first public paper.

In Section IV I have endeavoured to draw conclusions from the experiences gained upon this long journey.

I wish to thank most sincerely my friend and colleague, Sir Clive Baillieu, for so kindly writing the foreword to this book. I also owe very sincere thanks to my son, F. C. de Paula, himself an ex-service accountant, for his valuable help and encouragement.

To the editors of *The Accountant* and *Accountancy* I owe sincere thanks for their co-operation in allowing me to reproduce the matter published in their journals. I wish also to thank the Manchester Municipal College of Technology and the Polytechnic for allowing me to include papers prepared for them.

My thanks are also due to His Majesty's Stationery Office for kindly allowing me to include the minutes of my evidence given before the Company Law Amendment Committee.

Finally, I wish to express my very sincere thanks to my many friends and colleagues within the profession and in industry with whom I have had the privilege and pleasure of travelling down the road of life. They have been unsparing in their help to me. They have patiently borne with me and my strange ideas and have given me the priceless benefit of their experience, encouragement and advice.

My journey through life has taken me to many and various places, and readers may be interested to compare these stray notes with the records of their own travels, as I should like to compare their notes with mine. The interchange of individual observations, experiences and conclusions is the soundest foundation upon which to build up our professional technique.

F. R. M. de PAULA

8 Palace Gate, W.8
November, 1947

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Chapter I

Company Law Amendment

The author's evidence taken before the Company Law Amendment Committee on the 19th May, 1944.

THIS chapter is divided into two parts. The first part is the Memorandum submitted to the Committee by the author in 1943 and the second part is an extract from the minutes of evidence taken before the Committee on 19th May, 1944.

MEMORANDUM SUBMITTED BY MR. F. R. M. DE PAULA

GENERAL OBSERVATIONS

1. The form of presentation of the accounts of companies has been adversely criticized in the financial press in recent years and also in accountancy and other circles.

2. In my view the root of the criticism of the general practice regarding the form of presentation of the accounts of companies lies in the practical interpretation by directors and auditors of the part of Section 134 (1) (*b*), where it is stated that—"the Balance Sheet . . . is properly drawn up so as to exhibit *a true and correct view* of the state of the company's affairs."

3. I venture the opinion that a common interpretation, both by directors and auditors of the words "a true and correct view" is that the intrinsic position of a company must be not less favourable than that disclosed by the Balance Sheet, but that it can properly be more favourable without it being necessary in *bona fide* cases for either the directors or the auditors to bring this fact to the notice of the members of the company. If it is correct that the foregoing is a commonly accepted interpretation of the wording of Section 134 (1) (*b*), then your Committee may wish to consider whether this interpretation is satisfactory, or not.

4. This question of secret reserves has been debated in accountancy circles for many years. The Royal Mail Steam Packet Co. case, however, profoundly disturbed accountancy opinion upon this important subject and since that case I, and I think many accountants, have been in grave doubt as to whether the above mentioned interpretation of the words "a true and correct view" is satisfactory and therefore acceptable.

5. Experience, I suggest, clearly shows that, in the great majority of cases, the purposes with which undisclosed reserves have been created and used are strictly honest. In fact, many of the most successful and honourable companies in this country have been built up upon the policy

of ploughing back profits and part of these extra resources have been provided by means of the creation of secret reserves.

6. In the past, in my opinion, directors of companies have been, perhaps, unduly apprehensive regarding the effect that disclosure of full information in the accounts of companies might have upon shareholders, employees, customers, competitors and the community generally. Secret reserves were therefore built up with a view to providing for possible future losses and charges, the disclosure of which it was wished to avoid. My own opinion and experience is that the full disclosure of all reserves and their utilization does not result in adverse effects but, on the contrary, that the publication of full and informative accounts with the disclosure of all reserves has a most desirable result in that it creates a spirit of confidence in the management of a company.

7. The fact that the published accounts of companies in many cases show an understatement of the true position of affairs is, I submit, well known, and this fact, in my opinion, has resulted in a lack of confidence in the accounts of companies. Furthermore, as it is impossible to assess the amount of the understatement, critics, not unnaturally, incline greatly to exaggerate this factor.

8. In my view, therefore, the basic principle should be that the accounts of companies should be designed to give a full true and complete view, in broad outline, of the financial position of a company and of its true earnings for each accounting period. Were this policy generally adopted, in my opinion it would establish confidence. This policy would not prevent companies from building up all the reserves deemed necessary by their boards for the development and maintenance of their undertakings, and, if my experience is a sound guide, the honestly held apprehensions of directors regarding the ill effects of full disclosure in accounts will prove to be illusory.

The Balance Sheet

9. In my opinion confusion and misunderstandings in practice arise owing to the loose use of the word "reserve." I submit, therefore, that in the Act this important matter should be established and clarified upon the following lines—

(a) The term "reserve" should be used to denote sums set aside out of profits or other surpluses to provide against unknown future contingencies, to increase working capital, to equalize dividends or to strengthen the financial position of a company. A "reserve" should pre-suppose a profit or surplus and represent therefore, an appropriation of an available profit or surplus.

(b) The term "capital reserve" should be used to denote reserves which cannot properly be regarded as available or, if legally available, which the directors consider should not be made available for distribution as dividend, such as a surplus arising upon a revaluation

of fixed assets or a premium received upon an issue of shares or debentures.

(c) The term "provision" should be used to denote sums charged against profits or earnings to provide for known contingencies, commitments or for the diminution in value of assets. Such "provisions" represent a charge against earnings for known contingencies the exact amount of which cannot be ascertained, such as "provisions" for bad debts, discounts, depreciation of assets, deferred repairs, disputed claims, taxation, etc., which must therefore be estimated.

10. I submit that Section 124 (2) of the Act should be amended by adding to the items to be stated under separate headings in the Balance Sheet, the following—

(a) All capital reserves as defined in 9 (b), above.

(b) Capital redemption reserves in accordance with Section 46 (1) (c).

(I would suggest that the word "fund" should not be used in Section 46 (1) (c) in describing this reserve, as accountants generally consider that the word "fund" should indicate that the reserve is represented by "ear-marked" investments outside the business.)

(c) All reserves as defined above in 9 (a) and which are available for distribution as dividend.

(d) All provisions as defined in 9 (c) above. Provisions representing the estimated diminution in the value of assets such as depreciation of fixed assets, anticipated bad debts, and depreciation in the value of stock-in-trade should, I submit, in the Balance Sheet be deducted from the appropriate assets and if possible the amount of the provision should be stated. Provisions for such contingencies as deferred repairs, disputed claims and taxation should be suitably classified and separately stated in the Balance Sheet under the heading of Current Liabilities and Provisions.

(e) In my submission provisions for (a) depreciation and (b) obsolescence, should be dealt with separately in the Balance Sheet and also in the Profit and Loss Account. Depreciation represents the gradual exhaustion of capital outlaid in fixed assets in the course of earning revenue. The unknown factors generally are the effective working life and the realizable value of the discarded asset. Obsolescence, on the other hand, is a completely unknown factor. It is impossible to forecast whether any machine will in fact become obsolete or when in the future that contingency is likely to arise. It is not, therefore, possible to calculate this risk. I suggest, therefore, that this contingency should be provided for by appropriating available profits to General Reserve or to a special Obsolescence Reserve. In practice this contingency is commonly provided for by raising the rates of depreciation above that required to meet the normal depreciation factor. This practice, in my opinion, is not a

desirable one as it obscures the true view of the position of affairs. In my view, the provisions for depreciation are a necessary charge against earnings and should be separately stated, whereas provisions for obsolescence should be dealt with by way of appropriations of profits to provide reserves to meet this incalculable contingency. I would recommend, therefore, that the Act should give a definition of "depreciation" making it clear that this term does not include the factor of obsolescence.

(*f*) Provisions for proposed dividends and bonuses, in my view should be separately stated under the heading of Current Liabilities and Provisions and should be stated after deduction of Income Tax, provided that it is stated that they are subject to confirmation by the members.

(*g*) Section 124 (2) (*c*), I submit, should make it clear that (1) Goodwill and (2) Patents and Trade Marks should each be stated under separate headings. The wording of the present sub-section is not, I suggest, clear upon this point.

(*h*) Investments of a "fixed" nature and held for trading purposes.

(*i*) Investments other than trade investments and held as part of the liquid resources of a company.

(*j*) In all cases where there are Stock Exchange quotations of investments held by a company then the mean market value of such investments as at the date of the Balance Sheet should be shown by way of a note against this asset on the Balance Sheet.

(*k*) Debentures, mortgages and other long-term loans should, in my view, be suitably classified and separately stated under the heading of Long Term Liabilities.

(*l*) There should be separately stated under the heading of Current Liabilities and Provisions the following—(1) Bank Loans and overdrafts. (2) Other short term loans.

(*m*) The aggregate amount of the company's liability (if any) under guarantees should be separately stated by way of a note on the Balance Sheet, together with a note of the aggregate amount of the actual liability anticipated by the directors.

11. In my view, the basis of the provision for United Kingdom Income Tax should be made clear in a Balance Sheet, i.e. in the case of a Balance Sheet at the 31st December, 1942, whether the provision covers (*a*) ¾ of the 1942/3 Income Tax liability only or (*b*) the whole of the 1942/3 Income Tax liability or (*c*) in addition the whole of the estimated Income Tax liability for 1943/4 which liability will be based upon the profits for the year 1942. Practice differs greatly in this connection, but I submit that it is a matter of great importance that the point up to which this liability has been provided for should be made clear in the Balance Sheet.

12. I submit that under the heading of "Current Liabilities and

Provisions" in the Balance Sheet there should be separately stated the aggregate of the provisions for national defence contribution or Excess Profits Tax and the Income Tax liability for the current fiscal year.

13. I further submit that any provision for or towards the estimated future liability to Income Tax in respect of the fiscal year commencing after the date of the Balance Sheet should not be included under the heading of "Current Liabilities and Provisions" but should be grouped with Reserves.

14. I submit that in Section 124 (1) it should be provided that in the Balance Sheet the liabilities and assets should be reasonably classified. I would also suggest that in this sub-section and throughout the Act the term "current assets" should be used in place of "floating assets."

15. The provision in Section 124 (1) to the effect that in the case of fixed assets it should be stated in the Balance Sheet "how the values of the fixed assets have been arrived at" is commonly interpreted as requiring a statement such as "Fixed Assets at cost less Realizations and Depreciation." Without knowledge as to the reasonableness of the depreciation provision such a statement affords no guide as to whether or not these assets are stated at a satisfactory value. I have seen a Balance Sheet of a flourishing company in which land, buildings, plant, machinery and equipment were stated at £1. I do not feel that the present position is satisfactory but I appreciate the difficulties in connection with it. I would therefore suggest for consideration that Section 123 (2) should provide that in their annual report the directors should be required to state that the values at which the fixed assets are stated in the Balance Sheet represent, in their opinion, fair values upon the basis of the undertaking continuing as a going concern and in accordance with accepted accounting principles consistently maintained.

16. Section 124 (1) does not require any statement to be made in the Balance Sheet regarding the basis of valuation of current assets although this is a matter of great importance in the ascertainment of the financial position of a company. The chief factors appear to me to be as follows—

(a) *Inventories of Stock-inTrade.* The directors of a company must, clearly, be responsible for the valuation of this important asset. In my view the basis of valuation should be in accordance with accepted accounting principles consistently maintained, otherwise if the basis is altered from year to year the earnings of that year must be distorted. I would suggest that in the report of the directors they should be required to state the basis of valuation of inventories and if the basis has been varied from that adopted for the purposes of the preceding Balance Sheet then they should be required to state the amount by which the trading results for the period under review have been increased or decreased by reason of the variation of the basis of valuation of the inventories. If the directors create a provision for possible future depreciation in the

value of inventories then, I suggest, the amount of such provision should be separately stated in the Balance Sheet.

(*b*) *Sundry Debtors, Bills Receivable, etc.* I suggest that the Act should provide that the amount of any provision for bad and doubtful debts should be stated and shown as a deduction from this asset in the Balance Sheet.

(*c*) *Temporary Investments.* In my opinion the basis of valuation should be stated and in the case of investments for which there is a market quotation, as stated in paragraph 11 (*j*), the mean market value as at the date of the Balance Sheet should be stated.

(*d*) I would recommend that in their report the directors should be required to state that the values at which the current assets are stated in the Balance Sheet represent, in their opinion, fair values upon the going concern basis, and in accordance with accepted accounting principles consistently maintained.

Auditors' Report upon the Balance Sheet

17. I would recommend that Section 134 (1) (*b*) should read as follows—"Whether, in their opinion, the Balance Sheet referred to in the report is properly drawn up *in accordance with accepted accounting principles consistently maintained* so as to exhibit a true correct *and complete* view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company."

The Profit and Loss or Income and Expenditure Account

18. In the past, it appears to me, that the Balance Sheet has been generally regarded as the all-important statement, but I respectfully submit that the Profit and Loss Account is of equal if not greater importance. In my opinion the true value of a business undertaking is its capacity to earn profits. It is therefore, I submit, of vital importance that the annual Profit and Loss or Income and Expenditure Account should give a reasonably clear view of the financial results of the trading or other transactions of each accounting period and how those results have been arrived at.

19. The terms of Section 123 (1) have not, I submit, proved to be satisfactory. This sub-section does not give any indication as to what information shall be given in the Profit and Loss or Income and Expenditure Account. In practice, therefore, these accounts commonly give a minimum of information and disclose merely the final profit or loss for the accounting period, the appropriations to reserves and the dividends paid and recommended by the directors, with the addition of one or two items such as the following—(*a*) Depreciation of fixed assets; (*b*) Interest on debentures, loans, etc.; (*c*) Directors' fees; (*d*) Auditors' fees.

In my view the section should lay down the contents of the Profit and Loss or Income and Expenditure Account as Section 124 does in the case of the Balance Sheet.

20. I submit also that the Act should provide that all earnings, surpluses and income which do not represent normal earnings attributable to the current accounting period should be separately stated in the Profit and Loss or Income and Expenditure Account. Likewise I submit that all losses and charges which do not represent normal charges attributable to the current accounting period should be separately stated. The object of these recommendations is, of course, in order that the true earnings of each accounting period may be shown clearly by the accounts.

21. I submit that Section 123 (1) should provide that, in the case of a trading company, the Profit and Loss Account should contain a reasonable summary of the earnings, expenses, losses and charges for each accounting period and that the following should be separately stated—

(*a*) Net Sales.

(*b*) Miscellaneous Income (reasonably classified).

(*c*) Income, etc., which does not represent normal earnings attributable to the current year or period (reasonably classified).

(*d*) Cost of goods sold (excluding depreciation).

(*e*) Selling, Advertising and Distribution charges (excluding depreciation).

(*f*) General Administrative Charges (excluding depreciation and directors' remuneration).

(*g*) Financial Charges.

(*h*) Depreciation of Fixed Assets.

(*j*) The total amount paid to directors as defined in Section 128 (1) (*c*). This figure, I submit, should embrace the remuneration of all directors and therefore I recommend that sub-section (3) of Section 128 should be deleted from the Act.

(*k*) The aggregate of pensions and compensation for loss of office payable to past directors.

(*l*) Losses and charges which do not represent normal charges attributable to the current year or period (reasonably classified).

(*m*) Provision for E.P.T. or N.D.C.

(*n*) Provision for Income Tax specifying the fiscal period covered by this provison.

(*o*) Appropriations to Reserves.

(*p*) Dividends and Bonuses paid (less Income Tax).

(*q*) Dividends and Bonuses recommended (less Income Tax).

(*r*) Transfers to or from Reserves (reasonably classified).

Regarding (*j*) and (*k*) above it seems to me only reasonable that the members of a company should have knowledge of the aggregate

amounts of remuneration payable to all directors and past directors. The fact that these figures are not disclosed in accounts is a matter of criticism and in my view, therefore, it would seem wise to make disclosure compulsory.

22. In the case of non-trading companies, I submit that Section 123 (1) should provide that the Income and Expenditure Account should disclose a reasonable classification of the income and expenses, charges and losses, upon the same general lines as is recommended in paragraph 21 above.

23. In order to facilitate the reading of the annual accounts of a company I would recommend that the Act should provide that the corresponding figures according to the preceding year's accounts should be shown against each item in both the Profit and Loss or Income and Expenditure Account and in the Balance Sheet.

24. I would recommend that the Act should provide that the auditors' report under Section 134 (1) should make reference to the Profit and Loss or Income and Expenditure Account and state whether, in the auditors' opinion, that account is properly drawn up in accordance with accepted accounting principles consistently maintained so as to exhibit a true, correct and complete view of the revenue transactions of the company. This would make clear the importance of the Profit and Loss or Income and Expenditure Account and that the auditor has direct responsibilities with regard thereto.

Holding Companies

25. The present Act makes no reference to sub-subsidiary companies. I would therefore recommend that this omission should be rectified in order to clarify the position.

26. When a company holds a controlling interest in other companies, directly or through subsidiary companies, it is suggested that all of these companies should be referred to in the Act as "Subsidiary Companies" thus embracing all sub-subsidiary and sub-sub-subsidiary companies within the group.

27. I submit that the following sections of the present Act should be amended so as to include all subsidiary companies as defined in paragraph 26 above—Section 125, Section 126 (1), (2) and (3), Section 127.

28. In my view the terms of Section 127 (1), (*a*) and (*b*) are far from clear. For example, if the whole of the preference share capital (say) £150,000 of Company "A" were held by Company "B," the preference shares only having voting rights when their dividends are in arrear, the whole of the ordinary share capital (say) £100,000 by Company "C" and Company "D" had the power to appoint the majority of the directors of Company "A," then Company "A" would seem to be a subsidiary of Companies "B," "C" and "D."

29. In my view voting power is the essence of control. I would therefore submit that Section 127 (1) should be amended to provide

that the holding directly or indirectly in another company of more than 50 per cent of the voting power should constitute that company a subsidiary company under the Act.

30. I would also recommend that the Act should provide that the holding company's investments in and indebtedness to and from associated companies should be separately stated in the holding company's Balance Sheet, associated companies being those in which the holding company's direct or indirect interest does not give control but where the investment is held purely for trading purposes.

31. I would recommend that Section 126 should be amended so as to provide that the directors' statement shall disclose (*a*) the aggregate amount of the holding company's proportion of the losses, for the year or period, of subsidiary companies not provided for in the holding company's accounts and (*b*) the aggregate amount of the holding company's proportion of profits for the year or period of subsidiary companies not brought to credit in the accounts of the holding company.

32. Section 126 (2) should, I suggest, be amplified to provide for the reports of auditors of foreign controlled companies. As these audit reports are not generally in the British form I would recommend that the auditors of the holding company should be required to decide whether or not any statement contained in the report of the auditors of a foreign controlled company constitutes a qualification for the purposes of this sub-section.

33. I would recommend that the Act should make it illegal for a subsidiary company to hold shares in the holding company. In cases where that position already exists I suggest that a reasonable time should be given for the liquidation of these holdings.

34. I would recommend that the Act should provide that no director, other officer or employee of a holding company or of any subsidiary or associated company should be eligible to hold the office of auditor of any company within the group.

35. In cases where a subsidiary company is registered as a private company, I would recommend that such subsidiary should be required to publish and file its annual accounts.

Consolidated Statements

36. In my opinion it is not possible to obtain a true and correct view of the state of the financial affairs and the trend of the results of a group of companies, from an examination of the legal Balance Sheet and Profit and Loss Accounts of a holding company prepared in accordance with the terms of the present Act. Furthermore, the publication of the individual accounts of all subsidiary companies would not give the supplementary information required without considerable explanation of the inter-company relations, neither would such a course be practicable when there are numerous subsidiary companies spread over many countries with different currencies. A reasonably

clear view of the financial position and trading results of a group of companies can, in my view, be obtained only by the preparation of a consolidated Balance Sheet together with a consolidated statement of earnings. In my opinion the consolidated statement of earnings is the more important statement as it is the relationship of the consolidated earnings to the total capital employed that gives an indication of the value of the total capital invested in the group of companies.

37. I would therefore recommend that the Act should provide that to the accounts of every holding company there should be attached (*a*) a consolidated Balance Sheet and (*b*) a consolidated statement of earnings.

The Consolidated Balance Sheet

38. I submit that the following provisions regarding this statement should be included in the Act—

(*a*) On the consolidated Balance Sheet it should be stated whether or not the various items from the Balance Sheets of all subsidiary companies (as defined in paragraph 26) have been brought into the consolidated Balance Sheet. The reason should be given for the non-inclusion of any such subsidiary companies.

(*b*) In the case of the Balance Sheets of foreign subsidiary companies these should not be consolidated if, at the date of the consolidated Balance Sheet, it is not possible for reasons such as enemy occupation or exchange restrictions, to transfer liquid funds freely between the countries in which the controlled company and the holding company respectively are operating. If, for these or other reasons, the Balance Sheets of any foreign subsidiary companies have been excluded from the consolidation this fact should be stated together with the reasons for non-inclusion.

(*c*) If the Balance Sheets of any subsidiary companies are excluded from the consolidated Balance Sheet then the aggregate of the investments in and indebtedness to and from those companies should be stated as a separate item in the consolidated Balance Sheet.

(*d*) The investments in and indebtedness to and from associated companies should, in my submission, be separately stated in the consolidated Balance Sheet.

(*e*) In the case of subsidiary companies overseas, the accounts of which are in foreign currencies, the basis adopted, for the conversion of the various items in the Balance Sheets of those companies, should be stated.

(*f*) There should be separately stated the aggregate of goodwill items including the difference between the Balance Sheet values of inter-company holdings of shares and their par values less any undistributed profits at the date of the acquisition of such shares.

(*g*) There should be separately stated the interest of outside shareholders in the share capital of subsidiary companies, after

taking into account their proportion of reserves and undistributed profits or losses attributable thereto.

(*h*) I submit that, when applicable, the observations contained in paragraphs 9 to 16 above should also apply to the consolidated Balance Sheet.

The Consolidated Statement of Earnings

39. This statement should reconcile the aggregate earnings of the holding company and all of its subsidiaries for the year or period with the balance available to the holding company.

40. I submit that, when applicable, the observations contained in paragraphs 18 to 23 above should also apply to the consolidated statement of earnings. All inter-company sales should, of course, be excluded from the consolidated figure of "net sales."

41. I submit that in the consolidated statement of earnings the following items should be separately stated—

(*a*) Income, etc., which does not represent normal earnings attributable to the current year or period.

(*b*) Losses and charges which do not represent normal charges attributable to the current year or period.

(*c*) British and foreign taxation on profits or dividends provided for in the accounts of all subsidiary companies.

(*d*) Undistributed profits for the year or period less losses of subsidiary companies not provided for in the holding company's accounts.

(*e*) The interests of the outside shareholders of subsidiary companies in the consolidated results.

(*f*) War damage contributions and premiums.

42. I recommend that the basis should be stated upon which the results of foreign controlled companies have been converted into sterling for the purposes of the consolidated statement of earnings.

43. I would recommend that there should be attached to the consolidated Balance Sheet and statement of earnings a report from the auditors of the holding company to the effect that they have had produced to them the audited accounts of all the controlled and associated companies and that the consolidated Balance Sheet and statement of earnings have been properly prepared in accordance with accepted accounting principles consistently maintained. The report should conclude with an appropriately worded expression of opinion regarding the correctness of the view given by the consolidated Balance Sheet and statement of earnings.

Private Companies

44. In my view, as private companies enjoy the advantages of limited liability, their directors should be required by the Act to render an account of their stewardship in exactly the same way as the directors

of public companies are required to do. From the points of view of the shareholders and creditors of private companies this seems to me only equitable and reasonable.

45. For the above reasons, I submit that private companies should not be excluded from the provisions of Section 130 (1) and Section 110 (3). If this recommendation were not agreed to then I would respectfully submit that the foregoing two sections should not apply to subsidiary companies registered as private companies.

Directors

46. I submit that the directors and other officers of a company should be required to hold in their own names any shares in the company employing them and that all dealings in such shares should, therefore, be in their own names and, further, all such dealings should be reported to and be recorded in the minutes of the board.

47. I would also suggest for consideration that all such dealings during each year should be recorded in a separate section of the Annual Return (Section 108).

48. As recommended in paragraph 21 (*j*) and (*k*) my recommendation is that the aggregate of the remuneration paid to all of the directors and the aggregate of pensions and compensation for loss of office paid to past directors should be separately stated in the annual Profit and Loss Account.

49. If it were agreed that secret reserves should not be permitted, then I would suggest that the directors should be required to state in their annual report (Section 123 (2)) that all reserves and provisions, so far as it is possible, were disclosed in the Balance Sheet. This would make it absolutely clear that secret reserves were not permitted. As regards banking companies I would prefer not to express an opinion as to whether such a provision in the Act should apply to such companies as I have not had the necessary experience to justify my expressing an opinion.

50. I would suggest that it would be convenient if the Act provided that the directors' report should be regarded as a part of the audited Balance Sheet and Profit and Loss Account, so that it would be not necessary to repeat in the accounts information given in the directors' report.

Auditors

51. I would suggest that Section 132 should provide that the auditor of a company must be a member of one of the recognized bodies of professional accountants.

52. The relationship between the auditors of a company and the body of members is very remote, whereas the auditors' contacts with the directors of a company, of necessity, are very close. It is difficult to see how it is possible to strengthen the relationship between the members and the auditors, unless the Act provided that the auditor

should be required to attend all meetings of members and that members should have the right to address questions regarding the accounts to the auditor, who would be required to answer such questions provided that the auditor should be entitled to refuse to give an answer to such a question if, in his opinion, to do so was contrary to the interests of the company.

53. I have seen it suggested that the auditor each year should investigate and report upon the system of administration and management of a company, in addition to the conduct of the financial audit. In my opinion this is not a practicable proposition, as professional accountants generally, in my opinion, are not qualified to undertake a management audit. Were they required to undertake such increased responsibilities, then the professional accountant's system of education and training would require to be drastically altered. In my view, therefore, the auditors' responsibilities should be confined to the audit of the Balance Sheet and Profit and Loss Account. If a management audit were deemed to be necessary, then, in my submission, such an audit should be undertaken by members of a body specially educated and trained for this purpose.

14th September, 1943.

EXTRACT FROM THE MINUTES OF EVIDENCE

9833. (The Chairman): Mr. de Paula, I think you are Vice-Chairman and Joint Managing Director of Harding, Tilton & Hartley Limited, a Fellow of the Institute of Chartered Accountants, though not now in practice, and that you were formerly connected with the Dunlop Rubber Company, Limited?—Yes.

9834. You have kindly put in a memorandum which we have all read, and as it deals largely with accounting matters, with which Mr. Kettle is more familiar than the rest of us, I will ask him to put questions in the first place.

9835. (Mr. Kettle): I understand you are in general agreement with the recommendations of the Institute of Chartered Accountants, but that in certain respects you feel that disclosure should go further than their recommendations suggest?—Yes.

9836. I propose to ask you questions only in respect of points where your views differ from those of the Institute. I think the first point on your memorandum is in regard to the treatment of reserves and provisions, which you deal with in paragraph 10. As regards the definitions of those terms, quite apart from their treatment, would it be correct to say that there is no difference between you and the Institute?—No, none whatever.

9837. The Institute express the view that where the amounts involved are not material to the figures in the accounts, disclosure of the items is unimportant from the point of view of giving shareholders

substantially the information necessary to apprise them of the real meaning of the accounts. Mr. Robson, who represented the Institute, gave an illustration, I think purposely an exaggerated illustration; he put it in this way, "From the practical point of view, we feel that if you had a company whose capital was, say, £20 million and you had a reserve of, say, £5, it would be a little trivial to oblige that company to have a separate line in its Balance Sheet and account for a matter of £5, which is relatively insignificant in the ascertainment of the financial position of the undertaking." He is trying to draw a distinction between what is material and what is not material. What would you say to Mr. Robson's argument in that respect?—I feel that to draw that line in practice is very difficult. There is either a principle or there is not one. I do not think his illustration is likely to happen because a company of that size would not have a reserve of £5. I believe there is a legal maxim that the law does not worry about trifles—and, I submit, neither should accountants.

9838. What I imagine the Institute are mainly distinguishing are provisions representing close estimates of actual liabilities which are not ascertainable exactly at the date of the Balance Sheet, and other provisions for known contingencies and commitments where the amounts are material but cannot be ascertained with substantial accuracy. In the first case I think they have in mind items such as an estimate of £500 for rates, where the exact amount is not shown. Would you think it important that items like that should be separately shown as provisions, or do you think they should go under current liabilities and accrued charges?—Yes, I agree. An estimated liability, the amount of which you can estimate with a reasonable degree of accuracy does not, it seems to me, come under the heading of provisions, but should be shown as an estimated liability. Provisions are something rather different.

9839. That still leaves you in this position that you have to judge what is material and what is not material, even in a case like an estimate for rates?—Yes, it is a little difficult to draw that distinction, I agree.

9840. The Institute make one exception to disclosure of a provision of a material amount which cannot be estimated with accuracy, that is where disclosure would be detrimental to the company's interests, such as a claim in litigation against the company. They say that in those cases there should be a discretion to the directors not to show the amount in the Balance Sheet because of the detriment it would cause to the company, and that they ought to be permitted to include it under creditors. Have you any views on that reservation by the Institute?—I feel that that is a very difficult point. If you have a contingency reserve that is for all general contingencies, that is where I suggest one might provide for the type of item that you have in mind, being one which you do not want to disclose.

9841. But "contingency reserve" under the definition of the Institute is a reserve quite free, part of a surplus. Could you really, where you have a known claim, rely on an open reserve as a provision for that claim?—But why not? It is available for any needs of the company and supposing there is this claim, which you do not want to disclose, of £50,000, I would increase the contingency reserve by £50,000. That would disclose to no one specifically why it was done, but could that be said to be wrong?

9842. I will put it to you in this way; under the definition of "reserves" which include a contingency reserve, it is held out to the shareholders, or at least that is the intention of the Institute's definition, that that reserve is absolutely free from any claim, that it is part of the company's surplus. If you depart from that definition and say that free reserves shall be held to take care of the claims which you know are outstanding, do you not destroy the definition?—Yes, I agree, but it is only because of the need for non-disclosure that I would suggest dealing with it in that way.

9843. The Institute agree with you that it is desirable where possible to disclose the aggregate depreciation deducted from fixed assets. They suggest, however, that that is frequently impracticable because the information is not available from the books: I am not very clear from paragraph 10 (*d*) of your memorandum whether you agree with that when you say that the provisions for depreciation of fixed assets should be deducted where possible.—That is the reason. It is in the case of the old company which has no records from the time of acquisition of the asset where it is extremely difficult to do, in fact very often it is impossible.

9844. Would that also apply to deductions for shrinkage in the value of stock or provision for doubtful debts, or would you require those to be shown?—The provisions for doubtful debts, I suggest, should be shown. With stock I suggest that where having applied the lower of cost or realizable value, if the directors decide to make a provision of a lump sum for unknown future risks, that provision, I suggest, should be shown.

9845. That does not differ from the Institute?—No.

9846. I now come to paragraph 10 (*e*) where you think it is important that a distinction should be made between obsolescence and depreciation. You say "The unknown factors generally are the effective working life and the realisable value of the discarded asset." By "effective working life" do you mean the effective physical life or the effective commercial life?—The effective commercial life.

9847. You would agree that both the effective commercial life and the discarded value of the asset must be matters of estimate?—Yes.

9848. Where there are separate provisions made for depreciation and obsolescence, there is of course no difficulty in showing them in the accounts, but take a case where the income tax allowance for wear

and tear is 4 per cent; one company may think a reasonable provision for depreciation is 5 per cent, another company with a similar asset may think a reasonable provision is 10 per cent. Who is going to determine the measure of obsolescence which may be contained in the various rates which directors may settle for depreciation?—The way I *look* at it, obsolescence should not be included in those rates, because obsolescence is a factor which no one can calculate. Therefore my view is that depreciation should be calculated on the basis of the commercial life of the machine which although it might with expensive upkeep hang together for, say, 15 years, I would put at say, 10 years. That is depreciation; and my suggestion is that to cloud that with obsolescence confuses the whole issue. Obsolescence, I suggest, can only be provided by the appropriation of profits to general or a separate reserve. If I simply increase my depreciation provisions, am I not like an insurance company that is trying to set aside the premiums of each policy holder to meet his claims? Every machine will not become obsolete, but I do not know which one will or which one will not. If I provide for depreciation and obsolescence together I am, in effect, setting up an obsolescence reserve against each machine. If one goes obsolete after two years when it stands at, say, £10,000 on the books, I have a write-off of £10,000, and that is what often stops directors replacing; but if they have set up a separate obsolescence reserve which is available for any machine, they can write off that £10,000 against the reserve, and thus not touch the current earnings.

9849. I quite appreciate the theory upon which you are working, but my difficulty is to understand how, having regard to the illustration I have given you where there is no separate provision for obsolescence, the theory would become effective in the accounts. You suggest, for example, that there ought to be a definition of "depreciation." Do you think it would be possible to define "depreciation" in such a way that you could exclude from the definition the factor of obsolescence?—They are, I submit, two distinct things, and they are quite separate and distinct in my mind. One is the actual wearing out of the asset in the course of use, the other is due to the progress of invention. A new invention might render an old machine commercially useless for competitive production, and that may come at any time and one cannot calculate it.

9850. Turning to paragraph 10 (g), you suggest that the Act should require intangibles, such as goodwill and patents and trade marks, to be stated under separate headings. The Institute, as you know, take the opposite view and suggest that the Act should permit them to be amalgamated. Why do you think it important that those items should be stated separately?—I do not place any great importance on it, only I have always myself been puzzled as to what Section 124 (2) (*c*) meant, whether it did mean them to be separated or not. If the section means them to be shown together, I am quite happy.

9851. In paragraph 10 (*h*), you say "Investments of a 'fixed' nature and held for trading purposes" should be stated separately. Are those the investments which later in your memorandum you refer to as investments in associated companies?—Yes.

9852. In paragraph 10 (*l*), you suggest "There should be separately stated under the heading of Current Liabilities and Provisions the following—(1) Bank loans and overdrafts, (2) Other short term loans." Why do you think it is necessary to state separately other short term loans?—If you meant to amalgamate those two into one, I am in agreement.

9853. Why should not short term loans be placed under creditors? —I do not feel very strongly about it, but they are a little different from the ordinary trading creditors.

9854. Under paragraph 10 (*m*), you would require the company's liability under guarantees to be separately stated by way of a note on the Balance Sheet of the aggregate amount. Do you find occasionally you cannot quantify a contingent liability?—These are guarantees and although it is difficult to assess contingent liabilities they may sometimes amount to very considerable sums.

9855. There may be cases like guaranteeing the performance of a contract, I suppose, which would not enable you to put an aggregate sum in?—That would be impossible.

9856. Then you suggest that there should also be stated a note of the amount of the actual liability anticipated by the directors. It would be a duty, would it not, in properly prepared accounts, for that liability to be provided in the accounts?—Yes.

9857. If that were done would it be necessary for the anticipated liability for which the company would be liable, to be stated in a note? —No, if it has been provided for in the accounts, I agree it would not.

9858. In paragraph 11, you deal with setting out the basis of the provision for income tax, which goes a little further than the Institute, and in paragraph 13, you deal with the provision for the estimated future liability to income tax of the fiscal year commencing after the date of the Balance Sheet. That is liability which is not a legal liability it is a reserve?—Yes.

9859. It has been suggested to us that where the amount put aside is only on account of the future liability and not the full amount, there ought in addition to that to be a statement of the actual full amount of that liability for the subsequent year so that the shareholders can compare that with the amount that has been set aside towards it. Do you think it important that shareholders should know that figure?—I do not feel like insisting on it myself as long as you make perfectly clear the point up to which your income tax provision takes you.

9860. In paragraph 15, you say "The provision in Section 124 (1), to the effect that in the case of fixed assets it should be stated in the Balance Sheet 'how the values of the fixed assets have been arrived at,'

is commonly interpreted as requiring a statement such as 'Fixed Assets at cost less Realizations and Depreciation.' Without knowledge as to the reasonableness of the depreciation provision, such a statement affords no guide as to whether or not these assets are stated at a satisfactory value." If the gross cost of those fixed assets was stated, and the total provision for depreciation was deducted therefrom, would that meet your point of telling the shareholders whether they were stated at a satisfactory value?—I do not think it would. Take as an illustration the case of a very well-known company with land, buildings, plant and machinery standing at £1. If they showed "land, buildings, plant and machinery £500,000" and "depreciation £499,999," that would not appear to me to be a satisfactory value.

9861. Would you think in that case that the writing down of those assets to £1 was a cause of satisfaction or dissatisfaction to the shareholders?—My suggestion is that it does not enable them as shareholders to see the true position of the company. Those assets are obviously greatly undervalued.

9862. You suggest that the directors should be required to state "that the values at which the fixed assets are stated in the Balance Sheet represent, in their opinion, fair values upon the basis of the undertaking continuing as a going concern and in accordance with accepted accounting principles consistently maintained." Would you agree that the value of the fixed assets is very largely dependent upon earning capacity?—Yes.

9863. Would you further agree that the Balance Sheet is a historical document which shows what expenditure a company has made, what provisions it has made, and that it does not attempt in any way to show the realizable value, the replacement value, or in fact the going concern value of the assets?—No, I say it does show the going concern value.

9864. I thought you agreed with the suggestion that the going concern value of the assets is dependent on the earning capacity?—The going concern value is represented by the cost of acquisition less a proper allowance for wear and tear. As to whether directors have invested capital wisely or unwisely will be shown by the earnings of those assets.

9865. So that you are not suggesting that in giving the certificate as to fair value the directors should make any computation based upon the profits?—None whatever; simply on what they spend, less a provision for reasonable depreciation of those assets that are wearing out. That is a fair going concern value which, I suggest, the directors should confirm.

9866. My difficulty is in the use of the words "fair value," because a fair value means a different thing, I suggest, to the shareholders than the interpretation which you are seeking to put upon it.—I have said, "upon the basis of the undertaking continuing as a going concern"; I pin it to that.

9867. I know, but are the two necessarily compatible? You say, "fair values upon the basis of the undertaking continuing as a going concern." That is one thing. The other thing is a fair statement of the cost of those assets and the depreciation consistently provided on an adequate basis. If you had limited your statement to the latter I could understand it.—That is what I intend, that is to say the cost and reasonable depreciation for those assets that are wearing out.

9868. Do you think it likely, accepting your interpretation that the going concern values of the fixed assets are cost less a proper consistent provision for depreciation, that there will be many companies, old companies for instance, where the present directors would not have the information from the books and records which would enable them to make that statement?—Would that stop them giving my suggested statement? Surely they must be satisfied now?

9869. They would have a written down value, in one figure, of the plant. They would not know whether that had been consistently written down year by year. There may have been years when no depreciation was written off.—But I am not suggesting that. I am suggesting that with each year's accounts they have to say that the account for that year or period has been prepared on accepted accounting principles consistently applied. That is only from year to year. I am not applying that right back to the assets bought 20 years ago.

9870. Therefore, if you had plant which you had had for ten years and you had provided only five years depreciation, so long as you had provided the depreciation in that year they could give the certificate?—And the directors are satisfied that the total depreciation to date is reasonable. That is all they have to satisfy themselves about.

9871. In paragraph 16, you say that there should be a requirement to indicate the basis of valuation of current assets?—Yes.

9872. Is there any difference between the principles you suggest in that respect and those which have been advanced to us by the Institute?—I do not think so.

9873. You recommend that the directors in their report should be required to state that "the values at which the current assets are stated in the Balance Sheet represent in their opinion fair values upon the going concern basis, and in accordance with accepted accounting principles consistently maintained."—Yes.

9874. If your recommendations regarding the valuation of the current assets were given legal effect, would it not be the duty of the auditors to draw attention to any non-fulfilment?—Yes.

9875. Why do you think that in those circumstances there should be a requirement upon directors to give a certificate?—Because I feel that it is the directors who are responsible for the framing of the Balance Sheet and making the valuations, and it seems to me that it would only be fair that they should have to sign a certificate to the effect that they are satisfied that it gives a reasonable view. I feel that

they have shelved all responsibility on to the auditor. The auditor is there to cross-check, but I should like to see the responsibility clearly in front of the directors that they are responsible that the Balance Sheet valuations are fair ones.

9876. Passing to paragraph 17, in which you deal with the auditors' report, you are in agreement with the Institute that that should extend to the Profit and Loss Account?—Yes.

9877. The Institute are trying to get at the same thing as I think you are when you refer to "accepted accounting principles." They suggest that the consistent application of those accounting principles should be implied in the Act. Would you have any objection to that as an alternative to making the auditors affirmatively state that they had been applied, as you suggest, in their certificate?—What was at the back of my mind was that we do not want to crystallize practice or stop progress, that if we did it in the way I suggest, which, as you know, is the practice in America, the auditor would then be the judge as to what are the accepted accounting principles at that time, and accounting principles will develop, they may become stiffer, new circumstances may impose new principles, so that in this way the auditor is always the judge at the time when he has to sign his audit report as to what are the accepted accounting principles at that time. I would rather do that than pin it to an Act of Parliament, as that would tend to pin things down to a minimum at that time. My suggestion seemed to be more flexible, and to give more power to the auditor.

9878. The Institute suggest that instead of saying, as at present, a "true and correct view," the phrase should be used "true and fair view." I do not know whether you agree with me, but "true and correct" seem to be one and the same thing?—Very much so.

9879. And sometimes even a true and correct statement may give a misleading impression?—Yes.

9880. Whereas if you substituted the word "fair" that seems to me to place a greater responsibility on the auditor to ensure that the accounts do reflect a position which is not misleading. Why do you not agree with the Institute's recommendation in that respect?—My report was written before the Institute's, and I am not saying that I disagree with it. I added the word "complete." I think the word "fair" is better. I wanted to add "complete." It may be that this Committee will find much better words, but I wanted to make it clear to both auditors and directors that the auditors' report could not cover a material understatement of the position. In the past I think you will agree, Mr. Kettle, that it has been applied and accepted, and I have seen the case of a very big industrial company, with land, buildings, plant and machinery shown in the balance sheet at £1, and a clean audit report. I want something to make it clear that the auditor has to satisfy himself that it is not merely a partial view of the position but—I will accept your word—a "fair" view of the position.

9881. You have mentioned the word "complete." Do you not think that is going rather a long way when you are dealing with what after all must be a condensed summary of transactions extending over a year? Could the auditor really put his hand upon his heart and say, "That is a complete view of the state of the company's affairs, and of the profits"?—He only expresses an opinion. He says, "in his opinion." I used the word "complete" to convey that it is a complete picture.

9882. What I find it difficult to appreciate is how a Balance Sheet can be complete. For example, take shareholdings in subsidiary companies. There may be 12 separate companies. They are all merged together, their names are not given, the separate values at which they appear in the books are not given, their individual profits are not given. I rather fail to see how, when you have that one example, you could say that a Balance Sheet gives a complete view of the state of the company.—A complete view of a position is not a complete view of each unit in a company. I do not think it ever intends that.

9883. Turning to paragraph 21, you suggest that the Profit and Loss Account of a trading company should give a considerable amount of detail as to the trading transactions such as net sales, cost of goods sold, selling, advertising and distributing charges, and general administrative charges. Do you feel that there is any general demand on the part of shareholders for that detailed information?—No, I would not say I do.

9884. Do you think there is any substance in the view that such information might be valuable to trade rivals and a detriment to the company?—I find it very difficult myself to accept that. I have been in competitive businesses, and it is surprising the amount of information that they get about their competitors; but it does not come from accounts, it comes from the pressure of competition and market reports. Reports from salesmen that "A's goods are getting a bigger and bigger hold." That is what generates competition, and I cannot think myself that the accounts, following the American form, give anything to competitors that they can use to a company's detriment. I was concerned with a company in a highly competitive market where the main competitors were American. We therefore saw their Profit and Loss Accounts with net sales and cost of goods sold, and so on; they did not see ours, but that information did not attract one extra penny into our till.

9885. I suppose in the case of a big company where there was composite trading you might say that not much information could be extracted from these details, but I was only thinking of the case of the smaller companies dealing in one line of output, particularly those cases where they are dealing with a proprietary article, where one of the items which people do not want to disclose is advertising, for instance.—But I am not suggesting that advertising should be disclosed.

9886. No, but you are suggesting selling, advertising and distribution charges.—That is a big conglomeration.

9887. It might give a very good indication of the distribution and advertising expenses, in spite of the enquiries which can be made by travellers and other people. Do you think that this information would not add to what they already know?—They may be very interested, but I cannot think it would have any sinister effect. The effect is the success of the competitor's goods. That is felt long before the accounts ever come out.

9888. Looking at it from the shareholders' angle, this is what the representatives of the Institute said in evidence before us, as regards disclosing sales and items of that sort; "the information that could be given would I think be misleading unless it went very much further than is indicated in that suggestion; you really ought to break down the sales into the different categories, and show the gross profit in each category, before it would mean anything." What would you think of that view?—With great respect, I do not agree with their argument. To break it up into all the details obviously would be objectionable, but to show the sales in total seems to me reasonable. If we were members of a village cricket club and the treasurer at the annual meeting said, "Well, Gentlemen, as the result of the season's play we are £32 3s. 4d. on the wrong side," I do not think that any of us would accept it. We would say "We want to know what was taken in entrance fees, subscriptions and so on," and if a village cricket club wants an account, I think the shareholders of a company are entitled to be shown, in broad outline, the earnings and the outgoings.

9889. Do you think it would give a misleading impression in the case of a company which, say, dealt in coal and steel, where the coal showed a loss and the steel a profit? Do you think these figures would really give a proper view of the net sales, cost of production, and items of that sort?—I do. We are not looking at the business departmentally, we are looking at it as a whole, the same as the Balance Sheet is a picture of the whole and not of individual parts or sections, and so I think the Profit and Loss Account should reflect the trading as a whole and, therefore, I should disagree with the departmental position being disclosed.

9890. Another item you do not deal with in the information which you think should be supplied, is the question which has been raised before us by several witnesses, of the disclosure of directors' expenses. I suppose there is no criticism that can be made of expenses which are properly incurred and reimbursed by the company to the directors which are really the company's expenses, but it has been put to us that there is an increasing tendency to grant what are called expense allowances to directors where they render no account, and that those payments to them may contain an element of profit. Would you think it desirable that that item should be disclosed in the accounts?—I read the evidence with great interest, and I feel that there is a very real point there. My own feeling would be that if directors get an expense allowance for which they do not account, then it ought to be

disclosed. If they do account, it would not be disclosed; but if they render no account it should be added to the total emoluments which the Institute also recommended should be disclosed.

9891. In paragraph 30, you recommend "that the Act should provide that the holding company's investments in and indebtedness to and from associated companies should be separately stated in the holding company's Balance Sheet, associated companies being those in which the holding company's direct or indirect interest does not give control but where the investment is held purely for trading purposes." Do you think there would be any difficulty in practice in interpreting your definition in the Balance Sheet?—I have never found it. I have dealt for twelve years with a holding company which had, I think, almost every complication you can think of, and you can see this classification dealt with in others. I.C.I. and Dunlop use the term; Mr. Heyworth's company calls it "allied," but they all have that classification, and it is simply where you draw the line, above the line is subsidiary, below the line is associated or allied, whatever word you like to use.

9892. Do you know if in those cases you have mentioned, the use of the phrase "associated company" necessarily involves a shareholding?—It certainly is based on a shareholding, yes, definitely.

9893. Have you met cases where companies which are very closely associated in trade without an inter-company shareholding, deal with the debts and liabilities between them under the heading of "Associated Companies?—No, that would mean nothing to me. I should certainly not include those. It is only by way of a shareholding.

9894. That, I suppose, would be determined according to whether a shareholding was held purely for trading purposes?—Yes, in practice I do not think there is any difficulty because a shareholding like that is never acquired without it coming before the board, and there is a memorandum of what the proposition was. It is always perfectly clear whether it is an investment with a trading objective or whether it is simply an investment of surplus funds. There is no difficulty I think in practice in making that differentiation.

9895. You would not think one company might buy an investment for investment purposes, and subsequently enter into trading relations with that company?—It might, but that would all be disclosed to the board. Such transactions do not take place without some record. I have never found in practice the slightest difficulty in this connection.

9896. In paragraph 31, you deal with Section 126. I take it that where complete consolidated accounts were issued, that section would be unnecessary?—Yes.

9897. You would only require the statement where one company or more are omitted from the consolidation?—Yes.

9898. You suggest that the present requirements should be amplified by requiring that the aggregate amount of the holding company's

proportion of the losses not taken into the accounts should be stated and similarly, where profits are made, the aggregate amount of the profits left in the subsidiaries?—Yes.

9899. Do you think it also desirable to amplify that, by giving the figures of accumulated losses not taken into the account, and of accumulated profits not declared as dividends?—Yes. It would be a very significant figure.

9900. In paragraph 34, which raises an audit point, you recommend that the Act should provide that "no director, other officer or employee of a holding company or of any subsidiary or associated company should be eligible to hold the office of auditor of any company within the group." Would not you also require to extend the prohibition to a partner or employee of a director or officer?—Yes.

9901. I was just thinking that it was something to bring into line with the general prohibition which the Institute accept in the case of private companies. You would want to add those words?—I agree.

9902. I am a little puzzled why you extend that prohibition to associated companies, which after all are not controlled by the holding company. It struck me that you were going a little far on that.—Perhaps I am playing too safe, but you can get associated companies that are still very close to you. Wherever you draw your line, if you draw it at over 50 per cent, you might have an associated company where you have 45 per cent interest. I do not think it would be desirable for any official of that company to act as auditor of the holding company or of any of the other companies in the group. It seems to me that the auditor should be absolutely independent.

9903. If we may pass to paragraph 36, Consolidated Statements, as you say, your report was written before the Institute put forward their recommendations, but you go all out for a complete consolidated account?—Yes.

9904. You know the Institute give variations?—Yes.

9905. First of all, the complete consolidated accounts, secondly, the legal Balance Sheet with the consolidated accounts of the subsidiaries, in groups if necessary, and thirdly, the legal Balance Sheet with the subsidiary companies' individual accounts. Would you agree that any of those variations might be satisfactory?—Yes, but I would prefer consolidation, and I see no reason why it should not be the one choice.

9906. Take the case of a company which has only one subsidiary company; is there any real point in consolidation if you submit the accounts of that subsidiary company?—Unless you know what proportion of shares the parent company holds in that subsidiary, what the trade relations are, and many other things, those two accounts would not give a clear picture to a shareholder without a skilled accountant's summary to focus up the group position. Therefore I myself do not think it is an answer to give the shareholder the holding company's legal Balance Sheet and the Balance Sheet of the subsidiaries;

it is for the accountants, who are skilled in such matters, to focus up the group position, and that can only be done by a consolidated account. That is why I am so firm myself on the consolidated account.

9907. In paragraph 38 (*b*), you deal with certain exemptions from consolidation. Leaving aside the wartime conditions because they will not apply when anything is revised in the Act, I hope, you instance the case of consolidation of foreign subsidiary accounts where it would be impracticable. You say, "If, for these or other reasons, the Balance Sheets of any foreign subsidiary companies have been excluded from the consolidation this fact should be stated together with the reasons for non-inclusion." Would you leave it entirely to the discretion of the directors as to what accounts they might exclude?—Yes, provided that they make clear what they have excluded and why they have excluded it. The one that in peacetime I had to face myself was frozen currencies in, for example, Germany, and to my mind to consolidate those accounts would give a misleading picture, because if you added the liquid assets of a frozen German currency to the liquid assets elsewhere, the group position might reflect that there were very strong liquid resources, whereas part of those liquid resources would be frozen and could not be transferred. Therefore, my own view has always been that unless the funds can be moved from one country to another, amalgamated accounts would give a misleading picture.

9908. I gather you would not give the directors similar discretion in regard to a British company?—No, I do not think there is any reason for that.

9909. The only reasons that have been advanced to us, I think, are firstly, that it might be misleading to do so in the case of a company which was obviously insolvent, and, secondly, from the point of view of competition, where the information could be extracted if there were only one subsidiary company.—I do not feel my heart strings wrung by that argument, I must say.

9910. The whole idea underlying consolidated accounts is to give the shareholders a substantial view of the position of the group which they could not get without some such statement. One very often finds, in the case of insurance companies and banks and other big companies, that they have an interest in subsidiary companies which, compared to their total assets, is very unimportant indeed, it might be something representing 2 per cent, where the amalgamation would not really add to the shareholders' information. Would you think in such cases it would be practicable or desirable to allow an exemption from consolidation?—As long as it can be decided where to draw the line I agree that the interest could be so small in the aggregate that it would not add much to the information.

9911. Is it your view that if the interest in the subsidiary company was not more than 5 per cent of the total assets, there should be no requirement to consolidate?—Yes, I see no reason to object to that.

9912. I come to paragraph 43, the duty of the auditors in regard to consolidated accounts. You suggest that they should report "that they have had produced to them the audited accounts of all the controlled and associated companies and that the consolidated Balance Sheet and statement of earnings have been properly prepared in accordance with accepted accounting principles consistently maintained." The Institute suggest that a statement like that would be imposing upon the auditors of the company a liability which should not be imposed upon them because they could not make such a statement without auditing the accounts of the subsidiaries, and that their duty should be confined to having the right to make enquiries of the auditors of the subsidiary companies, and to saying that based on those enquiries they consider the consolidated account shows a true and fair positon. Would you not think that there is something in that argument?—That is really what my wording means; that the auditor has seen the audited accounts, but he has not audited them, he has had them produced to him and therefore he has accepted them, and, accepting those audited accounts as correct, he has checked up the picture and says it shows a true position. I am in agreement with you, and I think my words mean the same thing. If they do not, I agree with your argument.

9913. Why include associated companies, because in those cases the auditor would have no right to make enquiries of the auditors of the associated companies, and after all the accounts of the associated companies are not incorporated?—No, but he should see them. I have known of a case where the interest in an associated company was only 10 per cent, but it represented an investment of £600,000. That is a very important asset, and I know that that company's auditors certainly looked at the associated company's Balance Sheet, and I think properly.

9914. Yes, but what I cannot quite appreciate is why you require the auditor to say that the accounts of associated companies have been prepared in accordance with accepted accounting principles.—No, I am not saying that; I am saying that he should report that he has seen the audited accounts of the subsidiary and associated companies, and that the consolidated Balance Sheet is prepared on the basis of accepted accounting principles. Accepting those pieces in his jigsaw puzzle as correct, he has now put the jigsaw puzzle together and in his view it gives a correct picture. That is what he is saying.

9915. Only the jigsaw puzzle includes no figures of assets and liabilities of the associated companies?—No, the interests appear as an asset, "associated companies, £2 million," or whatever it may be.

9916. Passing to paragraphs 44 and 45, dealing with private companies, you suggest that the exemption from filing accounts should be withdrawn and that they should be placed on the same footing as public companies. At present public companies have to send accounts to shareholders entitled to receive notices. Do you think they should be

compelled to send accounts to all shareholders irrespective of whether they are entitled to receive notice of meetings?—I am afraid that is a legal point that I overlooked, but I think every shareholder is entitled to an account.

9917. Would you think it reasonable to require that every debenture holder should also be sent an account?—I do, yes.

9918. From the point of view of creditors, I would like to ask whether in your commercial experience you have found difficulty in ascertaining the credit-worthiness of private limited companies through the ordinary trade enquiry channels and bankers' references?—I really do not think I can give you a "Yes" or "No,"; it is a side of business that I have never had much to do with.

9919. Do you think that creditors, who do not normally take the trouble to make such enquiries and who simply grant credit, would take the trouble to inspect accounts filed at Bush House?—I think if they were very much concerned about a particular company, they would. I should.

9920. But these are the people who show no concern, they simply grant credit because they happen to think there is some business going, and they are the people, I suppose, one is trying to protect?—Whether creditors take advantage of the opportunity they have is their business, but I think the State surely is looking at it or presumably should look at it from the point of view of what information ought to be available to the general public. Whether creditors take advantage of it or not is their concern.

9921. Looking at it from the point of view of the shareholders in the numerous private companies which have had the privilege of not filing their accounts for 36 years now, I was wondering whether you thought that the extent of creditor's losses through lack of facilities for inspecting accounts, was so great as to call for an alteration of the Act, and so create in the minds of owners of private companies a feeling that there had been a breach of faith in these conditions under which they formed their private companies?—I follow the argument, but my own feeling is that if a business is registered as a limited liability company it should present accounts to its shareholders, and those accounts should be filed. It is the same as if it were made legally necessary now for holding companies to present consolidated accounts; those companies might say, "We have gone on for years and years and have never had it inflicted upon us." If it is right and proper, then I feel it should be introduced.

9922. If the privilege of not filing accounts were withdrawn, do you think there would be any reason why private companies, as a class, should continue to exist?—I agree that there would be very little privilege left.

9923. In paragraph 46, dealing with directors, you suggest "that the directors and other officers of a company should be required to

hold in their own names any shares in the company employing them."—Yes.

9924. Supposing a director wanted to raise a loan for the payment of taxation, and for that purpose wished to deposit his shares in the company as security with a bank, and the bank wanted the shares in its own name; would you not be rather creating a hardship if you would not allow him to do that?—That may be so, but the reason for my suggestion is that it seems to me to be undesirable that directors should have extensive operations in shares which no-one can trace.

9925. Would not that be met by your suggestion that a director should be compelled to disclose at each board meeting his dealings in the shares?—Yes, perhaps it would.

9926. You suggest that a record of those dealings should also be contained in a separate return to Bush House?—Yes.

9927. If that were done you might get inquisitive people looking at the records, and where a director had sold for perfectly good and proper reasons and not on inside information, they might put a wrong construction upon his sale, and the market price of the shares might fall. An alternative has been suggested, that at the annual general meeting the shareholders should have before them a note of the dealings of the directors, when they would have an opportunity of criticizing or asking questions, and where the directors would be able to give an explanation. What would you think of that as an alternative to requiring a record of the dealings to be put on the file?—I think it is quite a good alternative.

9928. In paragraph 49, you say—"If it were agreed that secret reserves should not be permitted, then I would suggest that the directors should be required to state in their annual report (Section 123 (2)) that all reserves and provisions, so far as it is possible, were disclosed in the Balance Sheet." If the Act provided that secret reserves were not permitted, why do you think it necessary for the directors to make a statement to that effect?—Perhaps it is excessive, but I feel that the old tradition to under-statement has been so ingrained—there is nothing corrupt about it—that I feel it might be advisable to bring it home to all boards of directors that the State does require a proper accounting.

9929. But if the directors did not comply with the statute requiring the disclosure of all inner reserves, would it not be the duty of the auditors to point it out in their report?—Yes, it would certainly. It may be that my suggestion is unnecessary.

9930. With regard to the auditors, paragraph 52, you say that the shareholders should be entitled to ask questions. They are entitled to ask questions at present. Is it your intention to suggest there that it should be a statutory duty for the auditor to attend the annual general meeting?—Yes, and that the shareholders should be entitled

to ask questions of the auditor. My experience is that they ask a question and the Chairman whispers to the auditor and the Chairman gives the answer. I am suggesting that as the auditor is the agent of the shareholders and acts for them and for them only, shareholders should, once a year at any rate, have the opportunity of asking the auditor questions.

9931. What the Institute say to that is that it would impose a burden on auditors, and very often expense to the company. They instance the case of many private companies where the auditors live a long way off and where at present they consult the directors and the directors say, "You need not trouble to come, nothing will be asked"; and very often the concern is a family concern and the shareholders are of the same mind. Would it not be rather imposing a burden on the auditors to attend such meetings?—I appreciate that, Mr. Kettle.

9932. What would you think of this further suggestion which has been made to us, that not only should the auditor attend the meeting but that it should be his duty to explain the accounts at the meeting to shareholders?—I think that is the Chairman's privilege and responsibility.

9933. I suppose in your memorandum you have had regard to accounts from the point of view of shareholders and creditors. It has been suggested to us that company accounts would be a very useful vehicle by which to provide information for the Government to direct economic matters and economic policy in the future. Do you think that accounts could be made to serve that purpose?—I think it would be very difficult indeed without making them so unduly complicated that they would be extremely difficult for the ordinary shareholder to understand. I think that if the State wants additional information, that should be provided separately by calling for the filling up of returns, or whatever it may be. I think there is everything to be gained by making accounts as simple to understand as possible, and if the State says, "We must have this, that and other information," accounts will or may be so unwieldy and complicated, that I think it would be defeating the main object of accounts.

9934. (The Chairman): As I have to leave shortly I am going to ask a few questions now. First of all, on this question of inner reserves, would you make any distinction in the case of companies such as banks and insurance companies?—I have specially said that I do not feel competent to express an opinion with regard to banks, as I have had no experience whatever.

9935. I observe in paragraph 9 (*b*) you say, "The term 'capital reserve' should be used to denote reserves which cannot properly be regarded as available or, if legally available, which the directors consider should not be made available for distribution as dividend, such as a surplus arising upon a revaluation of fixed assets or a premium received upon an issue of shares or debentures." First of all, I am not quite

clear whether you would leave it to the discretion of the directors, or whether you think it should be a statutory requirement?—I was really only giving my own definition, i.e. that a capital reserve should include that which they legally cannot touch, and that which the directors consider should not be touched.

9936. You include amongst the things they could not legally touch, unrealized surpluses on the revaluation of fixed assets and share premiums?—Yes.

9937. Realized accretions to capital you would leave to their discretion?—Yes.

9938. Going back to the question of depreciation and obsolescence, you say that obsolescence should be treated as a reserve?—Yes.

9939. Is not some provision for obsolescence a necessary charge? Does not everything become obsolete in time?—I suppose it does, but depreciation is simply, in my opinion, the writing off of machines or other assets on the basis of their commercial life which can be fairly accurately estimated. Obsolescence, as I see it, cannot be foreseen and is something quite apart from that altogether.

9940. Passing to paragraph 16 (*a*), is there not this objection to requiring a statement in the directors' report of the basis of the valuation of inventories and whether that basis has been varied from that adopted for the purposes of the preceding Balance Sheet, that if you take that course the auditors will be under no responsibility because they are not responsible for the directors' report, and should not the auditors be responsible to see that any statutory provisions in that report are complied with if there are any statutory provisions?—Oh yes. I was not suggesting taking any responsibility away from the auditors, but I wanted the directors to shoulder their own responsibilities.

9941. But the primary responsibility for the Balance Sheet is the directors' already?—Yes.

9942. So would not the only effect of transferring the item to the directors' report be to deprive the shareholders of the secondary protection of the auditors' certificate?—No, I had not that in mind at all.

9943. That was not your intention?—No.

9944. In paragraph 33, you recommend that, "the Act should make it illegal for a subsidiary company to hold shares in the holding company," and in cases where that position already exists you suggest that a reasonable time should be given for the liquidation of these holdings. You mean they should be compelled to sell?—Yes.

9945. Not that they should be bound to reduce the capital?—No.

9946. Would you consider it advisable to provide that in the meantime any shares held by the subsidiary in a parent company should be disqualified from voting?—Yes, I agree.

9947. In paragraph 34, you say, "the Act should provide that no director, other officer or employee of a holding company or of any subsidiary or associated company should be eligible to hold the office of

auditor of any company within the group." Do you mean to include the auditor as an "officer" of the company?—No.

9948. You have no objection to the same man auditing the accounts of all the companies in the group?—On the contrary.

9949. Someone I think suggested that was undesirable.—No, I think it is desirable where it can be done.

9950. There is some doubt as to how far an auditor is an officer.—Yes.

9951. In paragraph 50, you suggest that, "it would be convenient if the Act provided that the directors' report should be regarded as a part of the audited Balance Sheet and Profit and Loss Account." You are not of course suggesting that any responsibility should be thrown on the auditor?—None whatever. It is just a convenience, and saves repetition.

9952. It struck me that if put in that form, "that the directors' report should be regarded as a part of the audited Balance Sheet and Profit and Loss Account," the auditor might be compelled to audit the directors' report?—I accept the point, but I think the Institute have a similar recommendation.

9953. (Mr. Heyworth): In paragraph 21, you set out suggestions for the detail of the Profit and Loss Account. Would you consider that the smaller the company the more information the detail suggested would give to competitors?—Yes, but I still think we exaggerate the value of that information to competitors.

9954. I am inclined to agree with you on that point. Do you think that a small company trading in one commodity only would feel a sense of grievance if they gave that detail whereas a large company with all kinds of different transactions just gave a general picture?—I think that they might.

9955. Do you think that on balance the advantages outweigh the disadvantages?—Yes, I think it is a question of the common good, what is right. That is the ground on which I put it forward.

9956. Turning to private companies, paragraphs 44 and 45, you say, "From the points of view of the shareholders and creditors of private companies this seems to me only equitable and reasonable." That is the issue and filing of accounts. But the shareholders can get the accounts now, so there does not seem to be much in the point as it affects the shareholders. Is the only other point you have in mind about filing accounts, the protection of creditors?—That is for the protection of creditors, yes.

9957. Would you not say that experience has shown that creditors simply do not want that protection? There has never been any demand for the filing of private companies' accounts, has there?—I cannot say. I would probably agree, but there is presumably a reason why a public company is required to file its accounts, and therefore I suggest that whatever that reason is, it should also apply to private companies.

9958. What is the reason, because I do not think it is either of the two you have mentioned?—I think a creditor would on occasion, if a particular debtor is in question, search the register. It is a useful check.

9959. On the other hand there is no reason why, if you are trading with a private company, you should not say, "I cannot trade with you beyond these limits unless you show me what your position is," in which case they give up-to-date figures and not what you would get from the register if their accounts had to be filed? That is what actually happens, I suggest.—If the amount is material, yes.

9960. It has been suggested that there is a good deal of difficulty in checking whether companies file the returns which are required under the Companies Act. Do you think it would be putting a heavy obligation on the auditor if he were required to state that the returns required under the Companies Act had been made by the company?—If it is felt that that is desirable I take it that auditors would have to do it, but I should not have thought that that was the auditor's job.

9961. No, I can see why it has not become his job, but if in fact there is this difficulty of enforcement of the filing of returns, it would seem that you are almost entitled to look anywhere to find a practical way.—That would be a very practical way.

9962. (Mr. Hill Watson): Am I right in thinking that you wish to eliminate, if possible, the habit of material under-statement in accounts? —Yes.

9963. Turning to your suggested auditors' report in paragraph 17, it was suggested by Mr. Kettle that the word "fair" might be put in instead of "correct." I do not know whether it would be proper to say that "fair" implies no material under-statement?—Yes, I think it does.

9964. Accordingly, if "fair" implied that legally, then you would have no objection to the words "true and fair"?—I agree.

9965. I notice that you say, "in accordance with accepted accounting principles consistently maintained." I think that is very important, that they should be consistently maintained.—Yes, it goes to the essence of the whole thing.

9966. Yes. At present, while I have no doubt that all good auditors would always draw attention if there had been a change in the basis which might completely upset the accounts, there is nothing in the Act, I believe, to compel them to do so?—I suggest that there should be something to which the auditor can point and say "You cannot change the basis because I have to sign a certificate that you have not altered it."

9967. Unless the change is disclosed?—That is right.

9968. You think that it should be put down in black and white that the auditor can compel the directors either not to make the change or to disclose the change if it is made?—Yes.

9969. In a memorandum we were dealing with this morning, the suggestion was made that there should be appended to the Balance

Sheet a statement as to the arrears of preference dividend. Is that usually done in practice? Do you think it is necessary, or what is your view?—I think the balance of advantage lies in putting it on.

9970. It is probably not necessary, do you think?—I do not feel strongly one way or the other.

9971. In Section 133, which deals with the parties who may be appointed auditors, there is an exception in the case of a private company—"(1) (*b*) except where the company is a private company, a person who is a partner of or in the employment of an officer of the company." Do you think it right that the private company should have that exception?—No, I do not.

9972. Do you see any reason why the private company should have that exception?—No.

9973. (Sir Edward Hodgson): You recommend that directors should be required to state that the values at which the fixed assets are stated in the Balance Sheet represent, in their opinion, fair values. Do you contemplate that the figures appearing in regard to the fixed assets will fluctuate year by year in accordance with value changes?—I say, "on the basis of a going concern." That is the gross cost less reasonable depreciation, not the saleable value or the replacement value. As a going concern the company has spent so much money on these fixed assets. If it is land, it simply remains at cost; whether land goes up or down in realizable value, makes no difference; but if it is machinery which is wearing out there should be provision for reasonable depreciation. That is what I call fair going concern value, and that is what the directors have to say, not what its saleable value or replacement value is.

9974. Do you think that directors' reports are sufficiently informative?—No. There should be more information in them.

9975. Apart from certain arithmetical particulars, the directors are merely required by Section 123 (2) to furnish a report with respect to the state of the company's affairs. What meaning would you attach to the words "with respect to the state of the company's affairs"?—I think they should give a report, and I think directors' reports have improved. In most companies now the directors' report does tell the shareholders something about the year's work; but that is what I think they ought to do.

9976. Would you think we ought to go so far as to amplify that wording in order to make it clear that what the directors are required to do is to give a report of the year's working, the principal transactions, so that the shareholders will know what in fact the company had been doing?—Yes, I do.

(Sir Edward Hodgson): Thank you very much, Mr. de Paula.

Chapter II

Accounting Principles

A paper delivered before the Chartered Accountants Students' Society of London, on 6th March, 1946, and before the Birmingham and District Society of Chartered Accountants on the 8th March, 1946, also before the Incorporated Accountants Refresher Course at Balliol College, Oxford, on 6th April, 1946.

THE subject that we have to consider to-night covers a very wide field; it is impossible, therefore, for me to cover all the details. I shall attempt, however, to make clear to you the background of this whole problem and the basic principles that thread themselves through the whole of these recommendations. If these basic principles are clear to you, then all the details will fall naturally into place.

Some of you may wonder why so much attention has been directed, during recent years, to the laying down of a code of accounting principles. Recently a well-known industrial accountant in South Wales stated that the Cohen Report was the work of theorists. He was, I imagine, referring particularly to the recommendations regarding accounts, and if so, I wonder whether he is correct? Is this movement, which has been progressing over a number of years, the work of professors and long-haired thinkers who are far removed from the hard practical facts of life? That, apparently, is the opinion of the South Wales accountant I have referred to. I hope, however, to prove to you the exact opposite.

We are a very young profession. We developed very rapidly, extensively, and in directions never visualized by our founders.

As regards our thinking, the profession developed upon purely individualistic lines. Each one of us, having passed our final examinations, went our several ways and built up our own individual code of principles. There was no corporate thinking on these subjects, and therefore no guidance thereon from the councils of the various accountancy bodies. In these circumstances, naturally, wide differences in practice developed. The accounts of companies were presented in many different forms and the views of individual accountants on basic principles were very varied.

In several important directions there developed, I submit, loose thinking whereby we inter-mixed financial policy with basic principles. For this reason, in the valuation of assets, for example, accountants [illegible] under-statements.

[illegible] of profits into a business is obviously a most sound financial policy and is one upon which most of our successful

undertakings have been founded. But it is purely a matter of financial policy, and is it necessary to effect this by stealth?

This practice and the great lack of uniformity in the form of presentation of accounts greatly puzzled the public and there were many adverse critics. A few years ago *The Economist* had a series of five articles dealing with what that journal considered to be the unsatisfactory way in which accounts were presented and the lack of agreed basic principles. The writer blamed our profession for this state of affairs.

However, the profession had gone on happily and quite satisfied that all was well, when suddenly, out of a blue sky, an atomic bomb fell that shattered our self-complacency and startled and shocked the public. This atomic bomb was the Royal Mail Steam Packet case, which every one of you should read carefully if you want to understand clearly the root from which this whole movement has grown.

You will remember that Lord Kylsant, the chairman, and the company's auditor, were criminally prosecuted, and Lord Kylsant was found guilty. The basis of the charge was that the annual accounts and reports and a prospectus issued by that company were false and concealed from shareholders the true position of the company.

Briefly the circumstances were that during World War I, the company was very successful, made large profits and this continued up to the world-wide slump that developed in 1920. During the following seven years, the trading results of this company were very adverse and heavy losses were incurred. During this period, however, extraneous and non-recurring items which had nothing to do with the current trading, were brought to credit from year to year and amounted in total over the seven years to £5,000,000. By taking these items to credit, trading losses were turned into surpluses, but the fact that there was this secret reserve of £5,000,000 and that it was being utilized to bolster up current adverse results was not in any way disclosed.

These special items brought to credit were quite proper ones and this is made clear in the following statement from the Judge's summing up:

> "This is one of those difficult cases, but not impossible cases, which have occurred from time to time in the course of company transactions, where a document has been put forward in order to be acted upon (prospectuses and other things) and put forward in such a form that although it stated every fact correctly fact by fact, everything was correctly stated by the card, and yet the true effect of what was said was completely false and completely misleading."

From the foregoing you will see that these accounts were not wrong as regards the figures but the whole trouble arose from the form in which they were presented, that is, the lack of disclosure of the taking to credit of these special items, practically all of which originated in previous years.

It is important to note that the Presidents of the Institute and the Society and another well-known Chartered Accountant gave evidence for the defence to the effect that they would have signed the same report as the auditor of the Royal Mail Steam Packet Company did. It is clear, therefore, that the view of the profession at that time was that a company was justified in having secret reserves and drawing upon them without disclosing those facts. Regarding this the Judge stated:

> "It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they consider whether it is something which they are satisfied with or which they are not satisfied with? . . . Now what has happened as the result of that? . . . We know that there were Balance Sheets and Profit and Loss Accounts published for a period of seven years which did not disclose one way or the other whether the company was earning any profit or not. During those seven years there was expended out of those items which were mainly connected with the war, a sum of no less than five million pounds—not out of current earnings at all, but out of these items which in the main, not quite wholly, but in the main, arose out of the war. During all that period the shareholders were told nothing, and they drew their dividends presumably in the simple faith that all was well with the condition of the company . . . Now, if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met, is being fed by undisclosed reserves, it seems to me very difficult to see how the auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance as indicating the state of the company's affairs."

The Judge also made the following significant remarks:

> "It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of directors of a company are the agents and the trustees of the shareholders, that they owe full information, subject to proper and reasonable commercial necessity; they owe them full information, and it is their interests that they have to study; they are not to regard shareholders as people who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that a joint stock company is a creation of law."

The foregoing extracts from the Judge's remarks you will, I am sure, agree with me are very grave statements, and naturally accountants and industrialists studied this grim case very closely. In fact it had a profound effect on our whole thinking.

The immediate effect of the Kylsant case, so far as our profession is concerned, was that auditors decided that, if secret reserves were drawn upon to bolster up current earnings, this fact would have to be disclosed in the accounts. If not, the auditors would feel compelled to disclose the matter in their report. But the vexed question as to whether the existence of secret reserves should be disclosed was still left undecided.

Following the Kylsant case, several companies immediately proceeded to re-design the form of presentation of their accounts in the light of the lessons to be learnt from that case. This new form of presentation was on the broad basis of making the accounts as informative and easy to read as possible and showing separately any extraneous items which did not represent current earnings or charges. This new and improved form of presentation of accounts was warmly received by the financial press and thus public attention was focused upon this problem.

This development in accounting originated directly from the Kylsant case and was developed by the boards of great companies, advised naturally by their accountants. You will appreciate that the decision to alter the form of presentation rested with the boards of those companies and great credit is due to them for having blazed the new trail.

In 1942, the Institute of Chartered Accountants set up the "Taxation and Financial Relations Committee" and this committee at its first meeting decided to ask the Council's permission to the committee making the attempt to draw up a code of accounting principles. The Council agreed and, as you all know, these recommendations when completed were issued by the Council.

From the foregoing, I think you will agree that it is clear that this improvement was not developed by theorists, but by practical men of affairs who were facing a very grim reality. Furthermore, the boards of the companies that adopted the new form of presentation did so because they believed it to be the wise and ethical policy.

The Council's recommendations had a very profound effect and the movement towards more informative accounts developed widely and rapidly.

If you compare the Council's recommendations with those of the Cohen Committee, you will see that that Committee's recommendations are very closely in line with those of the Institute. In fact I think it is clear that the Institute's recommendations directly affected those of the Cohen Committee.

If you study the evidence given before the Cohen Committee you will probably be surprised to see what a great variety of witnesses supported the modern view on these matters. On the other hand, the old view was pressed by many witnesses and this view was in line with the generally accepted one of our forefathers, namely that all these matters should be left to the discretion of the directors of individual companies.

The old view was that it was sound policy and quite permissible to understate the position of affairs of a company, but the modern view is that accounts should be as informative and easy to read as possible, and that they should give a true and fair view of the state of a company's affairs and the trend of its earnings.

The Cohen Committee, however, adopted the modern view and this, you will agree, represents a complete revolution in our thinking.

The Profit and Loss Account

If you study the Kylsant case you will see that one of the lessons to be drawn from it is the great importance of the Profit and Loss Account. This is supported both by the recommendations of the Institute and the Cohen Committee, in both of which it is stated that this account is just as important as, if not more important than, the Balance Sheet. The reason for this is that it is most necessary to show clearly the true trend of the earnings of each accounting period and therefore that extraneous and non-recurring items should be shown separately. These principles are laid down in the Institute's recommendations and by the Cohen Committee, and also that the Profit and Loss Account should be based on accepted accounting principles consistently maintained, as otherwise the trend of earnings will be distorted. If the basic principles are altered, it is necessary that this fact should be disclosed and also the extent to which the earnings have been affected thereby.

The recommendations of the Institute and the Cohen Committee lay down certain items which must be shown separately in the Profit and Loss Account. There are, however, only three of these which I propose to deal with to-night.

(a) *United Kingdom Income Tax*

In the past there was great variety of practice in dealing with Income Tax. Some companies provided only for the proportion, to the date of the Balance Sheet, of the current year's Income Tax liability. Others provided for the whole of the current year's liability, although it overlapped the Balance Sheet date, whereas an increasing number of companies are now providing for the whole of the estimated Income Tax liability that will arise on the current year's earnings. Obviously it makes a great deal of difference as to which basis is adopted and therefore it is laid down that the exact basis of the provision in the accounts should be made clear. The Council recommends that the reserve for Income Tax should be based on the profits earned during the period covered by the accounts, but this basis could not be insisted upon by an auditor.

(b) *Reserves*

The Institute and the Cohen Committee recommend that transfers to and from reserves should be stated separately in the Profit and Loss Account.

(c) *Provisions*

The Cohen Committee's recommendations provide that the aggregate, if material in amount, of all provisions should be disclosed in the Profit and Loss Account, provided that if the Board of Trade is satisfied that the disclosure of any provision would be prejudicial to the

company's interests and is not required in the public interest, the amount concerned need not be shown separately, if appropriate words are introduced to indicate that a provision of this character has been made in arriving at the profit or loss.

Both recommendations provide that in the Profit and Loss Account the comparative figures for the preceding accounting period should be given.

The Balance Sheet

If you study the recommendations of the Institute and those of the Cohen Committee, both provide that the Balance Sheet shall give a true and fair view of the state of the affairs of a company and for this purpose that the items shall be grouped, which is, as you know, the modern practice.

The logical grouping is as follows:

(*a*) *Share Capital and Reserves*

Under this heading there will be grouped the following:

Share Capital
Premium on Shares
Capital Reserves
Other Reserves
Future Liability for Income Tax
Profit and Loss Account balances (debit or credit).

The extension of this total will of course show the aggregate interest of the shareholders in the undertaking.

(*b*) *Long Term Liabilities*

Under this heading will fall debentures and other loans redeemable upon a date beyond twelve months from the date of the Balance Sheet.

(*c*) *Current Liabilities and Provisions*

Under this heading will be grouped all the current liabilities and accrued charges, provisions for current taxation and other provisions, including provisions for proposed dividends.

(*d*) *Fixed Assets*

The various fixed assets will be itemized under this group and it is recommended that in each case the total cost and the total provisions for depreciation to date should be shown if that is possible.

(*e*) *Investments in and Advances to Subsidiary Companies and Trade Investments*

It is generally convenient to show these items under a separate group.

(*f*) *Long Term Claims*

Under this heading would be grouped claims maturing at dates beyond twelve months from the date of the Balance Sheet.

(*g*) *Current Assets*

Under this heading will be grouped the following:

Stock-in-trade and Work in Progress.
Trade Debtors, Prepayments and Bills Receivable.
Investments held as part of the liquid resources of the company.
Tax Reserve Certificates.
Bank Balances and Cash.

In the case of the Balance Sheet also, the recommendations are that the comparative figures according to the preceding Balance Sheet should be shown.

You will observe that a distinction is made between "Reserves" and "Provisions." In this connection the Institute stated that "the terms Reserves and Provisions are commonly regarded as interchangeable. Accounts would be more clearly understood if the term 'Reserve' were applied only to reserves which are free, and the term 'Provision' were confined to accounts set aside for specific requirements," and this suggestion has been adopted by the Cohen Committee.

Some of you may wonder why the future liability for Income Tax is grouped under the heading of "Reserves," but if you turn to the Institute's recommendations you will see that paragraph 31 provides that "any provision for (or in excess of) the estimated future liability to Income Tax in respect of the fiscal year commencing after the date of the Balance Sheet should not be included in current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described."

Holding Companies' Accounts

In the time available I cannot deal with this complicated and technical subject. Here again, however, the object of the recommendations is to show, by means of consolidated accounts, the true trend of earnings and the financial position of the group of companies as a whole. For this reason the Cohen Committee has recommended that it shall be made compulsory for all holding companies to submit to the shareholders of the holding company a consolidated Profit and Loss Account and Balance Sheet in addition to the legal accounts of the holding company itself.

The Institute's Recommendations IX and X

Many consider that recommendations IX and X are the most revolutionary ones made by the Institute. They cover depreciation of fixed assets and the valuation of stock-in-trade.

These are two most important matters and here again the basis of

these two recommendations is to avoid distortion of the true trend of earnings. To achieve this a consistent and sound basis must be adopted in each case.

As regards both of these important matters, practice differs widely and in my view there has been loose thinking, and here again we have mixed financial policy with accounting principles. The board of a company is solely responsible for financial policy, whereas the auditor should confine himself to accounting principles.

In the past it has been very common for the values of fixed assets to be materially understated by excessive provision for depreciation and in the same way for stock-in-trade to be materially undervalued.

Depreciation of Fixed Assets

The valuation of fixed assets for Balance Sheet purposes is not based on either their realizable or their replacement value but upon their cost.

Provisions for depreciation should be applied on a consistent basis, otherwise the trend of earnings will be distorted.

There are, as you all know, many different ways of calculating depreciation, but the Council recommends the straight line method.

Obsolescence is an important matter in this connection, and in the Institute's recommendations (para: 106) you will observe that it is recommended that unforeseen obsolescence and also an estimated increase in the cost of replacement of fixed assets are matters of financial prudence and that "neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts."

In the past there have been many arguments as to whether wasting assets such as a mine should be depreciated. You will see that the Institute recommends that depreciation should be provided for in the case of these assets.

Valuation of Stock-in-Trade

These recommendations are in my view of the utmost importance and are worthy of your very close study.

For many years our slogan has been that stocks should be valued on the basis of the lower of cost or market values, but in these recommendations for the first time the profession has attempted to define what we mean by "cost" and what we mean by "market value." I think when you study these recommendations that you will probably find these definitions of the Council to be very different from those commonly held in the past.

In this case again, the importance of the basis of valuation being consistent from year to year is emphasized.

Conclusions

I am afraid I have been able to give you only a very brief sketch

of this very important matter. I hope, however, that I have been able to make clear the background and the underlying principles.

This problem certainly deserves your closest study, as it goes to the root of accounting. For the first time the profession has carried out corporate thinking and the result has been a revolution in our outlook.

May I in conclusion again emphasize that whereas the old view was that it was permissible and financially prudent to understate the position of the affairs of a company (common reasons given being the danger of giving full information to competitors and the inadvisability of full disclosure to shareholders). But the new view is that it is the duty of directors by their accounts to convey information and not to conceal it, and therefore that the accounts of a company should give a full and fair view of the position of affairs.

Financial policy is a separate matter entirely and is one for the board of a company. No one denies the prudence of building up reserves, but these should be disclosed, except in the case of banks and discount houses. Furthermore, additions to and withdrawals from reserves and provisions should be made clear, if material in amount.

The experience of those who have travelled this road is that the new policy is a wise one and is in accord with proper ethical standards. Companies that have adopted the new form of presentation of accounts would all, I am sure, testify that, far from their having suffered any disadvantage thereby, they have gained materially by reason of the general confidence that this policy has generated. Those who think this way are of opinion that it is very bad policy to attempt to operate a company behind a smoke-screen of obscurity.

Mr. Basil Smallpiece recently stated "that the essence of professionalism . . . lies in the holding in trust for society of a *specialized technique and body of knowledge*; and the responsibility of those engaged in a profession is always to see that the knowledge and the techniques are developed for the common good and are neither polluted nor misused, even at cost to oneself."

That being the root of a profession, it is clear how vitally important it is that the profession should think out and build up an agreed code of basic principles. The Councils of both the Institute and the Society have made a good start, but there is still much to be done.

Chapter III

The Valuation of Stock-in-Trade or Inventories

A paper delivered before the Chartered Accountant Students' Society of London on 10th February, 1937.

For many years I have been disturbed by the fact that in practice so many different bases are adopted for the valuation of inventories, and further that there is not an accepted basic principle.

This matter is obviously of the utmost importance when one considers the considerable proportion of the capital invested in industry and commerce which is represented by inventories. It does, therefore, appear to be very necessary that we should endeavour to come to agreement as to the basic principles. In this connection I suggest that our profession should give a lead to industry by establishing what we consider to be the soundest and best practice.

Two summers ago a business journey took me round the world, which involved two months at sea. I took this opportunity to write a new edition of my book on Auditing and in these undisturbed surroundings I attempted to think out this problem afresh. I propose, therefore, to-night to describe in broad outline the conclusions I came to, and those of you who are interested will find them dealt with in greater detail in Chapter VI of my book.

Some of my conclusions are diametrically opposed to accepted practice, and no doubt some of you may come to the conclusion that on the sun-swept Pacific I became afflicted by midsummer madness. However, if these wild thoughts did lead to a general reconsideration of this vital problem, they have been worth while.

The orthodox principle is that inventories should be valued on the basis of the lower of cost or market value. This seems simple and all sufficing until we attempt to define cost and market value. I think that all practitioners will agree that both of these terms are interpreted in many different ways.

For example, in the case of the cost of stores and raw materials, there are the following methods—

(*a*) To value each lot on hand at the actual price paid for the consignment of which it formed a part. In the case of bulk stocks, this is not always possible.

(*b*) To assume that the quantity held in stock represents the latest purchases and to value at these prices.

(*c*) To value at the average cost during the year, i.e. the value of the opening stock plus the year's purchases.

The accepted principle as regards process and finished stocks is that they should be valued on the basis of factory cost, but factory cost is calculated in many different ways.

The raw material content of process and finished goods may be costed on the basis of any of the foregoing three methods.

As regards works overheads, these are applied in many different ways. For example, if the overheads are calculated as a percentage upon direct labour, this percentage will fluctuate with the rise and fall of the volume of production, and in practice, for inventory valuation purposes, the following methods are used—

(i) The percentage for the last quarter or month of the accounting period,

(ii) The percentage actually applied at the time the goods were manufactured,

(iii) The average percentage for the year, or

(iv) A standard percentage based upon a normal volume of production.

Our main difficulties arise in connection with the definition of market value, as there are two schools of thought, the first holding that the market value represents the replacement cost, i.e. the amount that it would cost to replace by purchase or manufacture the goods held at the date of the Balance Sheet; the second holding that the market value represents the estimated net amounts that the goods would realize.

Practice also varies in the application of the principle of the lower of cost or market value. In some cases this is applied to each lot and in others to groups. For example, in the case of a stock of raw materials at the Balance Sheet date, commonly this stock will have been bought during the year at widely varying prices. Some of us would contend that each lot should be valued at the lower of cost or market, and others that the total stock should be valued at cost and, if in total the market value were lower, the total stock should be written down to this figure.

Again, as regards the raw material content of process and finished stock, if at the date of the Balance Sheet the market value of the raw materials is below cost, some would write down the value of the stock by the amount of this difference and some would not.

In order to secure supplies of raw materials, manufacturers commonly place forward contracts, in which case at the date of the Balance Sheet there may be forward contracts at various prices, and if the market value of these raw materials at the date of the Balance Sheet is below the contract prices, some contend that provision for the

difference should be made in the past year's accounts and others claim that this is not necessary.

I am afraid that by this time the heads of the students amongst you must be in a whirl; that I can well understand, and personally, I suggest that the mind of the profession as a whole is in somewhat of a whirl on this particular subject. I have no doubt that, after you have torn my new theory to pieces, my mind also will be in a greater whirl than ever.

It is obvious that these many different methods of calculation must give widely varying results, which directly affect the final results shown by the accounts. I find it difficult to convince myself that this can be correct and, it seems to me, therefore, that it is of the highest importance that we should endeavour to establish basic principles.

When challenged with the fact that there are so many alternative methods of valuation, accountants generally answer that the basis to be adopted depends upon the circumstances of the case. This, however, is surely an evasion of the issue. Is the true reason that the profession collectively has not yet made up its mind upon these points?

Accountants cannot dictate to the business world the exact basis of inventory valuation, but it is, I submit, very desirable that the profession should enunciate the basic principles, as it would be of the greatest value to industry and practitioners to know what the accountancy profession considers to be the best and soundest practice. At present the profession speaks with many voices upon this subject.

The following are the basic principles which I submit for your consideration. For this purpose I am assuming the case of a manufacturer, so that we shall deal with all the various types of inventories.

In my opinion the all-important point upon which the greatest confusion of thought arises is in connection with the definition of market value.

In the case of stores and raw material, in my experience, the common practice is for market value to be interpreted as representing replacement value, but in the case of process and finished goods, market value is interpreted as representing the net realizable value. Here again I cannot convince myself that it can be correct to adopt these two distinct bases in connection with different types of stock.

The whole of the assets of a business, for Balance Sheet purposes, should, I submit, be valued on the "*going-concern*" basis and not upon the basis of their break-up value. When, therefore, we apply the replacement principle to stores and raw materials, are we correctly applying the "going-concern" principle? For stores and raw materials are not held with a view to resale in their existing form, but as component parts of manufactured goods.

All the various types of inventory, namely stores, raw materials, process and finished stock and also forward contracts for the supply of raw materials, are all merely stages in a continuous process which

results in the production of manufactured products. It seems to me, therefore, that the same principle should apply to all of the different types of stock and the only principle which, it seems to me, can be applied *is the net realizable value in the form of finished products.* That I suggest is the measuring stick that should be applied to all of the different classes of inventory.

My interpretation of the meaning of cost is, in the case of raw materials and stores, the year's average cost for each class, i.e. the opening stock plus the cost of the year's purchases divided by the total quantity. If this basis of calculation is impracticable, then I suggest that cost should be calculated by taking the latest invoiced prices plus, of course, direct expenses such as freight, duty, landing charges, etc.

As regards process and finished stock, I suggest that cost should be standard cost, which would be based on the current cost of raw materials and direct labour and overheads on the basis of a normal volume of production.

In my experience the most common basis of valuation is *current cost* and not *standard cost*, which will often give a widely different result. For example, the percentage of overheads will rise and fall with the volume of production and, therefore, for this reason the same item of stock, other things being equal, will be valued at a different figure at the beginning and the end of the year if the overhead percentage has fluctuated. If, therefore, the volume of production is falling, the overhead percentage will rise and, therefore, at the end of the year the stock will be written up to a higher value than at the commencement of the year. This does not seem to me to be correct, as it represents loading on to the stock the cost of idle capacity.

On the other hand, if valued at standard cost, then an individual item of stock will appear at the same value at the beginning and the end of the year, unless, of course, the standard has been changed due to variations in the cost of raw materials and/or labour, or variations in overheads due to altered production methods or efficiency.

Based upon the principle of the lower of cost or net realizable value in the form of finished products, the various classes of inventory would be valued as follows—

Stores

Stores are held for use and not for sale in their crude form. For example, coal represents an essential element in the production of the power required for manufacturing purposes.

I suggest, therefore, that the production account for each year should be charged with the actual cost of the coal consumed regardless of the fact as to the accounting period during which that coal was purchased. If, therefore, coal purchased in a preceding year is consumed in the following year, the basis of valuation for Balance Sheet purposes should be cost.

If, for example, at the date of a Balance Sheet the replacement value of stores is below cost, this does not mean that a loss has been incurred, but merely that the stores could have been purchased cheaper. If the stock is written down to the replacement value, then an artificial loss is added to the cost of stores for the past year and the cost of stores for the coming year is artificially reduced by a corresponding amount. In consequence the true cost of the stores consumed is not shown by the accounts of either of these years.

If the sales prices of the manufactured products show a profit margin, then a profit will be realized when the stores in question are eventually sold in the form of manufactured goods. In these circumstances, I suggest that cost is the correct basis of valuation for inventory purposes and that it could not be contested by an auditor.

Raw Materials

In my experience the common practice in the case of raw materials is also to value at the lower of cost or replacement value. I submit, however, that the basic principle should be the lower of cost or the net realizable value in the form of finished products.

Here again, if the replacement value of raw materials in stock at the date of the Balance Sheet has fallen below the cost price, no loss will result if there is a profit margin on the sale price of the finished products.

If, however, the selling price of the finished products has fallen at the date of the Balance Sheet and the cost of production plus selling and distribution charges in total exceeds the selling price, then, if that selling price is maintained in the ensuing year, it means that an actual loss will be incurred when the raw materials in stock are sold in the form of finished products. In these circumstances, therefore, I submit that the raw materials unquestionably should be written down to such a level that, as nearly as can be estimated, no loss will be incurred in the succeeding year upon the sale of the corresponding finished products.

Quite apart from theoretical principles, it is obvious that, if selling prices are at an uneconomic level, then a dangerous situation has developed and, therefore, that it is advisable to adopt a conservative basis of inventory valuation. In such circumstances, however, the valuation is largely a matter of judgment.

Forward Contracts for the Supply of Raw Materials

Manufacturers commonly maintain forward cover in order to ensure supplies of raw materials. The question arises, therefore, as to whether, if at the date of the Balance Sheet the market price of the particular materials is below the forward contract price, provision must be made in the past accounts for the difference.

In a case where a manufacturer fixes a forward contract for the sale of his products at a fixed price, the only prudent course is for him

immediately to cover the cost of his raw materials by placing forward contracts, so that in this way his profit margin may be secured. If at the date of the Balance Sheet the market price of these raw materials was below the forward contract price, I cannot see any reason, except cautious finance, why provision for the difference should be made in the past year's accounts. No loss has been incurred or will be incurred if the sale price of the finished products leaves a profit margin after providing for the cost of production, etc., taking the raw materials at the purchase contract prices.

In the same way, if forward contracts have been placed to provide raw materials for general requirements, that is to say in respect of manufactured goods which have not yet been sold, if the market price of the raw materials has fallen, it is no doubt a sound financial policy to provide for the difference, but, in my opinion, this is not essential, if there is a profit margin on the estimated selling prices of the finished products.

If, however, there has been a heavy fall in selling prices, for example owing to a price war, then it may be that the profit margins are wiped out and that, if these selling prices maintain, then at the contract prices for the raw materials, an estimated loss will be incurred when the manufactured goods are sold.

In these circumstances undoubtedly provision should be made in the past year so that, so far as can be estimated, the coming year will not incur a loss on the sale of the products manufactured from these raw materials. Here again, therefore, it is submitted that the governing factor is the estimated net realizable value of the finished products that will be manufactured from these raw materials. Nevertheless, circumstances may be encountered that require special consideration.

For example, supposing in the case of a manufacturer who, at the date of the Balance Sheet, has forward contracts representing, say, two years' supply, it might be that the selling prices of the finished products at that time showed a profit margin with raw materials taken at these contract prices.

Owing to the abnormal amount of the forward contracts, I suggest, however, that such a situation requires most careful consideration as it is impossible to forecast what selling prices will be for so long a period ahead. Therefore, very considerable risks are involved.

In such circumstances the replacement value of these raw materials is not, in my opinion, the vital factor, which is that these heavy forward contracts expose an abnormally large area of vulnerability and a comparatively long time must elapse before either the wisdom or imprudence of the heavy buying of raw materials is capable of demonstration and considerable risks are, therefore, involved.

In these circumstances it is obviously impossible to estimate the realizable value of the finished products that will be manufactured from these raw materials. The treatment, therefore, of these forward contracts becomes, I submit, a matter of judgment. Upon the principle

of sound financial policy and after weighing up all the circumstances of the case, drastic treatment may well prove to be the wise course.

This, it is submitted, in no way impairs the validity of the basic principles which I have advocated, for it will be appreciated that, as the circumstances expostulated are quite exceptional to the buiness, they require special treatment in the accounts.

In connection with this whole question of forward contracts the recent *Pepper Pool* case is of very great interest. Time does not permit of my dealing with all the circumstances of that case, but I think that the lesson to be drawn from it clearly is that, if there are forward contracts and the amounts involved are abnormally high, obviously a speculative situation exists that may result in serious losses. In such circumstances, therefore, it is necessary that these facts should be made clear in a prospectus and also, I submit, in a Balance Sheet.

Process or Partly Manufactured Goods

In the case of process and also finished stocks, the most commonly accepted principle in practice is, I think, the lower of cost or net realizable value.

Following the principles which I have enunciated, I suggest that the basis should be the lower of current *standard cost or the net realizable value in the form of finished products*.

The net realizable value would represent the sales price less allowances, selling and distribution charges, and the cost of completion of manufacture. You will appreciate that there is no question of anticipating profit by the adoption of this basis, as the net realizable value is only adopted if it is below cost and, therefore, there is no question of any profit in the valuation. The standard cost would cover raw materials, direct labour and direct factory overheads, applicable to the partly manufactured goods.

The cost, I submit, should not include selling, distribution and administration charges.

Finished or Completely Manufactured Goods

I suggest that exactly the same principles should be applied as in the case of process stocks, except that with finished goods the net realizable value will be represented by the sale price less allowances, general administration expenses and the cost of selling and distribution.

I also suggest that process stocks should be taken as a whole and valued on these two bases, the lower total of which would be adopted for Balance Sheet purposes.

As regards the raw materials content of process and finished stock, if the above basis is adopted, I see no reason, apart from the dictates of financial prudence, why the raw material content must be written down to replacement value if that is below cost value at the date of the Balance Sheet.

Damaged and Obsolete Stocks

In the case of all classes of the inventory, damaged and obsolete goods should be written down to the amount it is estimated that these goods will realize when sold in the form that it will be possible to dispose of them; in some cases this will be in the form of second-grade products and others in the form of scrap. Here again, allowance must be made for the costs of selling and distribution.

Unsold Produce, Etc.

In the case of tea, coffee and rubber estates, tin dredging and mining undertakings, it is a common practice to value the unsold production at the date of the Balance Sheet at the net amount subsequently realized. The object of this practice is to credit each year with the total amount realized upon the sale of the production of that year. In such cases, when at the time the accounts are being completed the whole of the unsold production has, in fact, been sold, there can be no objection to this practice. This stock should be described in the Balance Sheet as "at net amount subsequently realized." In this way, it is made clear that the profit has been put back into the year during which such stock was produced. It will be appreciated, however, that this practice is a distinct departure from the ordinarily accepted principles of inventory valuation. It is, however, the established practice in the case of undertakings of the type referred to.

Conclusions

Considerations of financial policy commonly result in the adoption of a conservative basis of inventory valuation, and this is obviously prudent, but this financial policy is quite apart from the question of the basic principles that should govern inventory valuation.

It is, however, of great importance that consistent bases should be adopted from year to year, otherwise, if the basis of valuation is altered, the trend of the operating results for the year will be distorted. In my view, it is of the utmost importance that the proprietors of a business should be given a clear view as to the trend of the normal earnings of the concern. If, therefore, the basis of inventory valuation has been altered and the amounts involved are material in amount, then, in my opinion, this fact and the amount involved should be made clear to the proprietors of the business.

I am afraid that to-night I have, in all probability, merely increased the confusion of thought on this particular subject, but may I conclude by suggesting that the newly formed Accounting Research Association should endeavour to clear our minds upon this matter, which is of such vital concern to the industrial world.

Chapter IV

The Valuation of Stock-in-Trade or Inventories—(*contd.*)

A paper delivered before the Nottingham Chartered Accountant Students' Society on the 13th November, 1946.

In 1942 the Council of the Institute commenced to issue a series of recommendations upon "Accounting Principles." This was a most important event with a deep significance, for it was the first time that we accountants attempted to think out, upon a corporate basis, our problems and thus our Council has given helpful guidance to every member.

In the past we developed upon a purely individualistic basis, we each laid down our own code of principles and hence our practice showed wide differences in method and in the form in which accounts were presented.

The Council's recommendations on accounting principles have had a profound effect and directly influenced the Company Law Amendment Committee's recommendations regarding the accounts of companies.

Every one of you should, if you have not already done so, study closely the eleven recommendations of the Council and also the Cohen Committee's report on company law amendment.

From a study of these two documents you will find that views upon this matter have undergone a complete and revolutionary change.

The time honoured policy of secrecy in connection with the form of presentation of accounts has been abandoned and the new policy is that accouuts should be a vehicle for conveying information and not for concealing it. You will therefore find laid down the basic principles upon which accounts should be prepared and particulars of the information that must be given.

A most important change is the spotlight that has been turned upon the Profit and Loss Account. The Cohen Committee has stated that the Profit and Loss Account is just as important, if not more important, than the Balance Sheet. It is only by means of the Profit and Loss Account that the trend of earnings can be seen and thus an idea obtained as to whether the return upon the total capital investment in a concern is satisfactory or not.

This basic factor you must fully understand, as it will make clear to you the reasons for the detail recommendations. You will find that great precautions are taken to ensure that the true trend of earnings is not distorted by the methods applied in preparing the accounts.

It is not possible for me to cover the whole of the Council's recommendations in the time available to-night. I propose therefore to deal with Recommendation X only, as in my view it is the most revolutionary of any of the recommendations issued to date by the Council. This recommendation deals with the valuation of stock-in-trade, and I think that you will agree with me that it is a complete departure from the principles that we all acted upon in the past. Some of the new ideas upon this important subject may come as a shock to some of you.

The valuation of stock-in-trade is a vital factor in the preparation of the accounts of commercial and industrial undertakings. It is a little surprising, therefore, that until recently the profession had not attempted to establish agreed basic principles that should be applied in this connection. We had the accepted slogan that the basis should be the lower of cost or market value, but there were many conflicting interpretations of both the terms "cost" and "market" value. There was no general agreement as to these all-important and basic factors.

When challenged as to the lack of accepted basic principles, the common answer was that this was not possible owing to the great differences in the conditions and circumstances regarding the stocks of various businesses. But is this a satisfactory answer? The nature of the stocks may be different, but I submit that the basic principles of their valuation surely should be the same.

As you know, in its recommendations on accounting principles, the Council of the Institute has dealt with this very important subject and thus has laid down what it considers to be the best practice. Recommendation X, which is the one in question, many consider to be the most revolutionary of all the recommendations issued by the Council up to date.

Every one of you should study Recommendation X very closely indeed, and you will find that the principles there laid down are very different from those generally held in the past.

The basic premises at the root of these recommendations are, firstly, that the true trend of the earnings of a business must not be distorted by the bases adopted from year to year for the valuation of stock-in-trade, and secondly, I submit that questions of financial policy should be kept quite separate and distinct from the basic principles that should govern these valuations.

In the past, in particular by the writing down of items of stock, we have distorted the trend of earnings by deflating the past year's earnings and inflating the future year's earnings by an exactly similar amount. This see-saw effect of the writing down of stock has not, I feel, always been fully appreciated.

For example, let us assume a case where in Year I a merchant purchased 10,000 articles at £1 each. During the year he sells 5,000 at 30s. each, thus realizing a gross profit of 10s. per item sold which equals £2,500. That result would be shown by his Trading Account if at the end of the year he valued his stock of 5,000 items *at cost*, i.e. £1 each.

But let us suppose that at the end of the year prices are falling and the merchant decides instead to write his stock down to 15s. per unit, which would be 5s. below cost. Let us also further suppose that the whole of the stock was sold in Year II at 25s. per item. The following are comparative Trading Accounts, column "A" showing the position if the stock were valued at cost, i.e. £1 per unit and in column "B" if the stock were valued at 15s. per unit.

YEAR I

	A	B		A	B
	£	£		£	£
Purchases			*Sales*		
10,000 at 20s. each .	10,000	10,000	5,000 at 30s. each .	7,500	7,500
Less: Stock at year end					
5,000 at 20s. each .	5,000				
5,000 at 15s. each .		3,750			
Cost of Goods Sold .	5,000	6,250			
Gross Profit . .	2,500	1,250			
	£7,500	£7,500		£7,500	£7,500

YEAR II

	A	B		A	B
Stock			*Sales*		
5,000 at 20s. each .	5,000		5,000 at 25s. each .	6,250	6,250
5,000 at 15s. each .		3,750			
Gross Profit . .	1,250	2,500			
	£6,250	£6,250		£6,250	£6,250

The results of the two methods are therefore as follows—

Gross Profits	A	B
	£	£
Year I . . .	2,500	1,250
Year II . . .	1,250	2,500
	£3,750	£3,750

The total profit for the two years is, of course, the same under each method of stock valuation but the facts are that—

	£
In Year I 5,000 articles which cost 20s. each were sold for 30s. each resulting in a gross profit of	2,500
In year II 5,000 articles which cost 20s. were sold for 25s. each resulting in a gross profit of.	1,250
Total	£3,750

This represents method "A" above which, I submit, shows the true trend of earnings. Method "B" distorts the earnings of both years, Year I is understated by £1,250 and Year II is overstated by a like

amount. These distortions are brought about by the writing down of the stock, under method "B," by £1,250 at the end of Year I.

In order to ensure that the true trend of earnings is not distorted, I submit that stock in good condition should be maintained from year to year in the Production and Trading Accounts at cost. Thus, when stock is sold, there will be charged, against the proceeds of sale, the actual cost of such stock, regardless of the fact whether it was purchased or manufactured during the current or in a preceding year.

This is the first basic factor I wish to underline, as being a method that will make certain that the trend of earnings is not distorted.

At this stage we have been considering the treatment of stock solely from the point of view of the Production and Trading Accounts.

Now, turning to the Balance Sheet, stock should be valued upon the basis of the lower of cost or net realizable value. Where applicable, therefore, provision must be made in order to reduce the total cost valuation to the amount "which it is estimated that the stock can be realized either in its existing condition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal."

Stock that is not in first-class condition by reason of being damaged, out of fashion, obsolete, unsaleable or unuseable, requires special consideration. Each item of this stock should be valued at the net amount that it is estimated that such stock will realize in the condition in which it will be sold, i.e. as "seconds" or as scrap. The total provision under this head should be shown as a separate item in the Profit and Loss Account and added to the provision deducted from the stock in the Balance Sheet.

The total amount of any provision for anticipated losses upon the realization of stock, I submit, should be charged to the Profit and Loss Account as a separate item and shown as a deduction from the stock-in-trade item in the Balance Sheet. From management's point of view this is a very important factor. (I am referring to the accounts produced to management and not to the published accounts)

If this practice is followed it will be appreciated that the trend of gross profit will be shown from year to year consistently upon the basis of cost against sales and thus distortions are avoided. In the Profit and Loss Account management can see as a separate item the total amount that has been provided for anticipated losses upon the realization of the stock.

In the Balance Sheet the total provision for possible losses upon realization is shown as a deduction from the stock item and each year this provision will be reconsidered and increased or decreased by an appropriate transfer to or from Profit and Loss Account.

What I have endeavoured to describe is, of course, an entirely new method for handling this matter in the accounts, and the basic reason is to focus the whole position clearly and to avoid the distortion of

gross profits. The importance of this you will, I feel sure, readily appreciate. I must point out, however, that this method does not form part of the Institute's recommendations, but it is submitted as one that will make sure that the spirit of the Council's recommendations is complied with.

I now wish to endeavour to make clear what we mean by the terms "Cost" and "Market Value" in connection with the valuation of stock-in-trade.

The following are common bases used for calculating cost for stock-taking purposes—

Unit Cost. "Upon this basis, each article, batch or parcel is valued at its individual cost."

This method is suitable in cases when the number of items is not very considerable and when the value of the individual items is high, e.g. the stocks of jewellers, or of a dealer in motor cars. It is not possible of application in cases of bulk stocks, such as chemicals or oil in vats.

First in, first out. "This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases."

This basis conforms with accepted views regarding the handling of stocks, i.e. turning stocks over so that they do not deteriorate through remaining for long periods at the bottom of the stock pile.

When it is suitable it is simple to operate, but it is not always applicable.

Average Cost. "This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business."

In cases where the "First in, first out" method cannot readily be applied the "Average Cost" basis is commonly adopted.

Standard Cost. Under this basis stocks of process and manufactured goods are valued on the basis of standard costs. Such costs are based upon a normal volume of production and current costs of direct labour and materials and factory overheads.

This basis eliminates the distortions brought about by the influence of fluctuating volume on fixed overhead charges.

Last in, first out. This basis assumes that goods sold or consumed are those which have been the shortest time on hand and that the quantity held in stock represents the earliest purchases.

In America this method has many advocates, and it has advocates here.

In my opinion this basis is directly contrary to accepted views regarding the handling of stocks, and has several other objections that I have not time to elaborate. I am not in favour of it.

In the case of partly and completely manufactured goods the costs

should naturally comprise the cost of direct labour and materials expended upon such goods up to the date of the Balance Sheet.

Regarding overhead charges, only factory overheads should be considered. Practice varies, and you will observe that the Council in its recommendation states, regarding overheads, that if "expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade, or alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned."

This is a most important matter, and many of us have overlooked the freak results that can be produced when fixed overheads are included in cost when valuing stock, e.g. the same item of stock may be at a much higher value at the end of the year than at the beginning, merely because the *volume* of production has fallen.

My own recommendations are as follows and in that order of preference—

(1) to exclude all overheads,
(2) to exclude all fixed overheads,
(3) to value at "Standard Cost."

But in all cases it is of prime importance to be consistent from year to year in the basis of valuation adopted.

Turning now to a consideration of the term "market value" the first point is, do we understand that to mean the estimated replacement value or the realizable value in the form that the stock will be sold in the ordinary course of trade? You will appreciate that there may be a material difference between these two values.

In the past the most generally accepted interpretation was, I think, replacement value and that basis still has many advocates.

The m [illegible] ion value, which you will see th [illegible] h it is estimated that the stock [illegible] lition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal."

This is a very different conception. A merchant often buys goods and sells them in the same condition. But a manufacturer buys raw materials and stores and converts them into a manufactured product, which he sells. He does not, therefore, buy raw materials with a view to selling them in their original state.

The basic factor is, therefore, the saleable value of the *finished* product and not the estimated cost of replacing the raw materials, stores, process and finished goods.

This may be a new conception to some of you, as also may the Council's statement that "the fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date."

The Council also states that "on the other hand, if at the time of valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss." And further that in estimating the realizable value "regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal."

Replacement value still has strong advocates, and you will observe that the Council recommends that if this basis is adopted then, in the Balance Sheet, the stock should be described as being "at the lower of cost or *replacement value*," and the Council states further that "in no case should it exceed market value as described above." Thus the Council recommends that the exact basis upon which stock has been valued should be made clear in the Balance Sheet.

The next point for consideration is how exactly the principle of the lower of cost or market value is to be applied.

There are three bases—

(1) to consider each article in stock separately,

(2) to group articles in categories having regard to their similarity or interchangeability or

(3) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

In the past the most common basis was (1) above and failing that (2). The aggregate method is a comparatively recent innovation. Bases (1) and (2) will result in a lower total value than the aggregate basis will.

The majority of practitioners favour (1) or (2) on the grounds that they are more conservative.

My dictionary defines the word "principle" as "a law or doctrine from which others are derived." That does not imply that our principles must be upon the most conservative basis. I think that in this connection there has been loose thinking and that we have intermixed accounting principles with financial policy. We are directly concerned with principles, but the proprietors of a business are solely responsible for financial policy.

If stock is valued in accordance with an accepted accountancy principle then, I submit, the auditor must be satisfied. The directors of such a company might consider it prudent financial policy to appropriate out of available profits a reserve covering (say) 50 per cent of the total value of the stock. That would be a matter of policy with which an auditor, as such, is not concerned. Any such reserve should be disclosed in a company's accounts.

You will have observed that the Council in its recommendations lays down that stock-in-trade "may properly be valued on the basis of the lower of its aggregate cost or of its aggregate market value."

In the profession opinions are sharply divided upon this point; in fact many are violently opposed to this new principle. The Council further hold, therefore, that an "equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value."

Thus the Council's recommendation is a compromise between the old and the new conceptions upon this important point.

The modern view, as I understand it, is that the aggregate method should be the basic principle, and that it should be left to the proprietors of a business to create reserves to cover all of the other contingencies of the future. By this means cautious and prudent financial policy may be applied, whilst at the same time maintaining uniform basic accounting principles.

Those of you who have not studied this important subject through modern spectacles, will probably be astonished by the new views upon this matter. It is a problem of great importance that should be thoroughly explored by every one of us.

To-night we have merely considered one of the eleven recommendations of the Council—every one of them should be studied and thoroughly understood by every member of our profession. Furthermore, we should not drift into the state of mind that there is now no further need for thought. Conditions change, new responsibilities open out before us and if, therefore, we are to rise to our opportunities we must be ever watchful and adjust and add to our code of accepted basic principles. We live in a changing world and our practices and professional technique must be adapted and altered accordingly.

NOTE. The quotations in this paper are from Recommendation X of the Council of the Institute of Chartered Accountants in England and Wales.

Any opinions that I have expressed in this paper are my own and not necessarily those of the Council of my Institute.

Chapter V

The Form of Presentation of the Accounts of Holding Companies

A paper delivered before the Chartered Accountant Students' Society of London on 7th November, to the Birmingham Chartered Accountant Students' Society on the 9th November, and to the Sussex Branch of the South Eastern Chartered Accountant Students' Society on the 14th November, 1934.

ONE of the most marked developments in industry and commerce in recent years has been the advent of the holding company, that is an organization comprising a parent company which holds a controlling interest in one or more subsidiary companies and in some cases sub-subsidiary companies.

Control is effected by the acquistion of a sufficient number of shares in each subsidiary to give the holding company more than 50 per cent of the voting power, or, where the holding company has power directly or indirectly to appoint the majority of the directors of the subsidiary and thus influence the policy of that company.

In this way the holding company may control a large group of companies and there are many such organizations to-day of an international character and comprising a large number of companies in countries all over the world.

From the commercial point of view there are many advantages in this type of organization, and in my opinion it is a natural development the benefits of which experience has proved.

On the other hand, as is always the case, there are weaknesses and one of the great difficulties is that this type of organization raises accounting problems of considerable complexity, in particular as regards the form of presentation of the holding company's accounts.

It is this problem I wish to discuss with you to-night, as it is of great public interest, and one which is in no small measure exercising the mind of our profession at the present time.

This form of organization is capable of being improperly used as a cloak to hide from shareholders the true position of the combine in which they are interested, and there have been grave abuses and spectacular crashes that have shaken public confidence. It is for this reason that this problem has loomed so large in recent times.

At the outset I wish to make it clear that the views I shall express are my own and not necessarily those of the board of my company. Furthermore, in order to illustrate various points I propose to use the 1933 accounts of the Dunlop Rubber Co., Ltd. In doing so I am not, however, suggesting that these accounts represent the final solution.

of this vexed problem; they are merely to illustrate how that company has attempted to overcome the various difficulties involved in this question.

In the time available it is not possible for me to deal with all the accounting problems that arise in connection with holding companies. I propose therefore to confine myself to the general form in which I suggest the accounts of a holding company might with advantage be presented.

In the first place, however, it will, I think, be helpful for me to endeavour to make clear to you the general situation and the principal complications and difficulties in connection with this problem.

The holding company itself and each of the subsidiary and sub-subsidiary companies is a separate legal entity. Each company therefore has its own board of directors, is a self-contained unit and operates under the company laws of the country in which it is registered in exactly the same way as any ordinary company.

The claims of creditors of each subsidiary company can legally be enforced only against the assets of that company and such creditors have no claim whatever against the assets of the holding company or of any of the other companies within the combine unless such debts have been guaranteed by another company within the group. In practice, in order to preserve its goodwill, a solvent holding company would not usually allow a subsidiary company to default and would in all likelihood provide funds in order to satisfy the creditors of an insolvent subsidiary, but, as already stated, the legal rights of the ordinary unsecured creditors of a subsidiary are confined to the assets of that company.

In order to comply with legal requirements, each of these companies must prepare its own accounts and submit them in the ordinary way to its shareholders in general meeting.

It is important to bear in mind that the various individual companies within a combine are not branches of one legal entity embracing them all. The connection is by means of shareholdings, i.e. the holding company is merely a majority shareholder in each of the subsidiaries, in addition to which some of the subsidiary companies may in turn be majority shareholders in sub-subsidiary companies.

In the Balance Sheet of the holding company its interest in the subsidiaries is represented by investments in and advances to the various subsidiary companies. These investments and advances, as you will be aware, under the Companies Act, 1929, must be separately stated in the holding company's Balance Sheet.

A holding company, for trading reasons, may be interested in a company but, whilst holding a substantial interest therein, such interest may be only 50 per cent or less. Such companies are commonly known as associated companies. In these circumstances the holding company

is not in a position to exercise effective control and is either a 50 per cent or merely a minority shareholder.

You will appreciate that the holding company may have a large family, including children, grandchildren, and even great-grandchildren. If, further, this large family is scattered all over the world, you will appreciate that it requires an extremely sound and efficient organization in order to exercise effective control, and a vital part of that organization will be an efficient accounting system.

As regards the form of presentation of the accounts, there are no particular points in connection with the accounts of the subsidiaries with which I think I need detain you, but many difficult and complex points do arise as regards the accounts of the holding company itself.

As you will be aware, the Companies Act, 1929, contains certain provisions dealing specifically with the accounts of holding companies. But the general opinion, I think, is that these provisions by themselves are inadequate for solving this complicated problem.

Under Section 126 it is provided that there shall be annexed to the holding company's Balance Sheet a statement signed by the directors stating how the aggregate profits and losses of the subsidiary companies have, so far as they concern the holding company, been dealt with in the accounts of the holding company.

This statement must also say to what extent provision has been made for the losses of subsidiary companies either in the accounts of those companies or of the holding company or of both. Further, it must state to what extent the losses of subsidiary companies have been taken into account in arriving at the profits and losses of the holding company as disclosed in its accounts.

It is important to note, however, that it is not necessary to specify in this statement the actual amount of the profits or losses of any subsidiary company or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner.

I have been largely quoting the actual words of the section, which, as an example of lucidity and draughtsmanship, leaves, to say the least, something to be desired, in addition to which it seems to me to be ineffective in attaining the underlying objective.

In a brilliant paper on holding companies delivered before the International Congress on Accounting in 1933[1] when dealing with the terms of this section, Sir Albert Wyon stated: "I venture to think that the particulars required by the Act to be disclosed are of so general and vague a character as to be quite insufficient to supply shareholders with the information necessary for them, if they are to have a just view of the earnings of the enterprise in which they are interested and of its prospects. The provisions which I have epitomized may

[1] "Holding and Subsidiary Companies—Accounting Principles involved in the Treatment of Earnings and Valuation of Holdings," published in *The Accountant* of 5th August, 1933.

indeed have the unintended effect of providing justification for directors who wish so to prepare the accounts of a holding company as to conceal from those chiefly interested the actual results of its activities."

I entirely agree with these views of Sir Albert Wyon, and I will endeavour to explain why I am of opinion that the terms of the Act fall short of the real solution of this important problem.

Although the members of the holding company are shareholders of that company only, they are directly interested in the fortunes of the whole group. Therefore, in order to obtain a clear view as to the state of their investment in the parent company, it seems reasonable to suggest they they should be enabled from year to year to learn something of the character, the financial health and the earning capacity of the parent *and* all the children.

The true test of the value of any commercial enterprise is its capacity to earn profits. A clear picture, therefore, of the earnings of the whole group of companies is the only means by which the members of a holding company can judge as to the success or failure of the combine in which they are interested.

I would like to emphasize this point strongly, as in my view it is the key to the whole problem.

There has developed a strong demand for the production of so-called "consolidated Balance Sheets," which are of great assistance, but in my opinion a consolidated earnings statement is of far greater value and importance.

As the law stands, however, it is not compulsory for a holding company to present to its shareholders any view of the earnings of the combine as a whole. In fact the board of a holding company, acting strictly within the terms of the Companies Act, can present a Profit and Loss Account which gives no indication whatever as to the true earnings of the group as a whole. For under the Act, all that the directors of a holding company are bound to do each year is to lay before the company in general meeting the Profit and Loss Account of the holding company itself.

In drawing up this Profit and Loss Account the board could take credit for the dividends declared or to be declared by the profitable subsidiaries and make no provision for the holding company's proportion of the losses of the unprofitable ones. If such losses were substantial in amount, I think you will agree that a most incomplete view of the earnings of the combine would be given to the shareholders and although, in the statement annexed to the Balance Sheet the directors would be bound to state the fact that such losses had not been provided for, they would not have to disclose the amount of the aggregate losses.

You may ask, "What about the company's auditor?" But what can he do, except qualify his report to the effect that in his opinion the value of the investments in subsidiaries is overstated in the Balance Sheet! Such a statement would be a warning, but it would give no

indication as to the amounts involved and therefore the shareholders would still be completely in the dark as to the true position of affairs.

Furthermore, it is possible for the directors to declare as dividend only a proportion of the available profits of subsidiaries. Such undistributed profits would therefore in effect form a secret reserve, as to the existence of which the shareholders of the holding company would not necessarily have any indication.

If in a subsequent year the profits of the combine fell, it would be possible for the subsidiaries to declare dividends out of the undistributed profits accumulated in past years. Such dividends could be properly taken to credit by the holding company, as income of the year in respect of which they had been declared. There is nothing in the Act making it compulsory for this fact to be made clear, and if it were not, then the results shown by the holding company's accounts would give a distorted view of the earnings of the combine for that year. There is nothing wrong in the declaration of dividends out of profits accumulated in the past, but dividends paid out of past profits of subsidiaries and received by a holding company represent, in effect, the drawing upon reserves created in the past.

I am strongly of opinion that in the case of all companies it is of the utmost importance that abnormal items taken to credit should be separately stated in the Profit and Loss Account, as otherwise, if these items are material in amount, shareholders will obtain an incorrect view of the normal earnings of the undertaking for the particular year in question. The great importance of this factor was made abundantly clear in the Royal Mail Steam Packet case, with the salient features of which you are all no doubt acquainted.

At the time that the shares in a subsidiary are acquired by the holding company there may be in existence undistributed profits in the accounts of that subsidiary. If in a subsequent year the whole or part of such undistributed profits is distributed as dividend, then in the hands of the holding company such dividend represents capital, and not income.

In arriving at the sum paid for the shares, the undistributed profits will have been taken into account and such undistributed profits will therefore be included in the purchase price. In these circumstances, on receipt of the dividend from the subsidiary by the holding company, the proportion (if any) representing profits which were undistributed at the time of the acquistion of the shares should be deducted from the cost of the investment, thus reducing its value in the Balance Sheet.

Inevitably in the case of combines there are inter-company transactions, and for example Company A may sell goods or services to Company B. If at the date of the Balance Sheet Company B has part of these goods in stock, they will be valued in the ordinary way at cost, if the market price has been maintained. This cost price will include the profit on the sale charged by Company A.

Companies A and B are separate legal entities and notwithstanding the legal position that A could sue B for the price charged, the fact remains that, from the point of view of the group as a whole, such a sale is a mere inter-company transaction; therefore, unless and until the goods in question are sold to customers outside the group, no true profit can be said to have arisen.

A similar point arises if one company does work of a capital nature for another within the group, such as a sale of plant. The selling company may properly charge a price that included a reasonable profit and the purchasing company will capitalize this item at the invoice price. In the accounts of the holding company credit should not be taken for this profit which lies in the accounts of the supplying company, as this again merely represents in effect an internal or inter-company adjustment.

A debatable point arises as to the set of accounts in which the adjustment for inter-company profits should be made. In my view, this provision should be made in the books of the holding company, as in the case of subsidiaries the position may be complicated by reason of the existence of minority interests.

I have endeavoured to describe to you the general situation as regards earnings and the principal points arising in connection therewith. The problem is as to how best to obtain a clear view, firstly of the earnings of the holding company itself and secondly of the earnings of the group as a whole. This is a complex and difficult question, the solution of which we are all earnestly trying to find. I shall refer in some detail to this matter later.

Turning now to the Balance Sheet position, here again we must remember that each company within the group is a separate legal entity and each one, including the holding company, has to prepare its own Balance Sheet, and you will remember that these individual Balance Sheets only are of direct interest to the creditors of the respective companies,

As regards the form of presentation of the Balance Sheets of the subsidiaries, here again there are no special points that I propose to deal with, but very important questions arise in connection with the Balance Sheet of the holding company.

In addition to being a majority shareholder in the subsidiary companies, the holding company not infrequently acts as the banker for the group and provides the subsidiaries with any necessary finance in the form of loans and/or advances on current account. On the other hand, surplus funds of subsidiaries are often deposited with the holding company.

In this way a considerable proportion, in some cases practically the whole, of the capital of the holding company may be represented by investments in and advances to subsidiary companies. For example, if you refer to the legal Balance Sheet of the Dunlop Rubber Co. (pages

78 to 81) you will observe that out of total assets of £22,200,000 investments in and advances to subsidiary companies amount to £11,800,000 and associated companies £1,090,000. On the other side of the Balance Sheet you will see that the amounts owing to subsidiary and associated companies are £1,500,000 (page 80).

In the case of a pure holding company, i.e. one that itself does not carry on any trading activities, it is common to find that practically the whole of the assets are represented by investments in and advances to subsidiary and associated companies.

Under the Companies Act, all that a holding company is bound to submit to its shareholders is its legal Balance Sheet in which the aggregate of the investments in, the advances to and the advances from subsidiary companies, must be stated separately, in addition to which the basis of valuation of these investments which are regarded as fixed assets must be stated.

Such a Balance Sheet gives no indication (*a*) as to the financial position of the combine as a whole; (*b*) as to the financial position of the subsidiary companies as a group; (*c*) whether the investment in subsidiary companies is represented by, e.g. 99 per cent net tangible assets and 1 per cent goodwill or vice versa; (*d*) what proportion of the assets of the subsidiary companies is represented by fixed and what proportion by current assets; (*e*) what are the liabilities of and (*f*) what are the reserves of the subsidiary companies.

Without this information it is obviously impossible to form any idea as to the financial position of the combine as a whole. For example, it is possible for the Balance Sheet of the holding company to show a strong liquid position although many of the subsidiaries may be in a hopelessly insolvent condition. This has been the position revealed in the case of many of the spectacular failures in the past.

Taken by itself, I think all will agree that the legal Balance Sheet of a holding company cannot possibly give a clear view of the financial position of the group of companies as a whole. It is for this reason that there has developed an ever increasing demand for fuller and more detailed information. In this connection Lord Plender recently stated, "having regard to the extent to which business is carried on through the medium of subsidiary companies, in my opinion the time has come when the whole question of further and more adequate disclosure should be reviewed." With that opinion I think we are all in entire accord; it rests therefore with those responsible for the administration of holding companies, in co-operation with accountants, to concentrate upon finding the solution of this difficult problem.

Obviously, as is the case with every undertaking, in order to obtain a clear view of the financial position and progress of a holding company, it is necessary to see on the one hand the earnings and on the other hand the financial position of the whole group of companies. If this information is available, it is possible to judge whether the aggregate earnings

represent a reasonable return upon the total capital invested in the group, and to follow the trend of this relationship from year to year. This, it seems to me, is the paramount factor and the crux of the whole problem, the solution of which, I suggest, lies in the direction firstly, of the preparation of a consolidated statement of earnings and secondly, of a consolidated statement of the assets and liabilities either of the whole group of companies or of the subsidiary and sub-subsidiary companies as a group. In the latter case this statement will show exactly what is comprised in the items appearing in the holding company's Balance Sheet, i.e. investments in and advances to and from subsidiary companies.

A further alternative, which in my opinion has much to recommend it, is to prepare a consolidated statement of assets and liabilities of the subsidiaries and also a consolidated statement embracing the Balance Sheets of the subsidiary and sub-subsidiary companies and the Balance Sheet of the holding company. In this way the financial position can be seen from three important viewpoints. Firstly, the position of the holding company would be shown by its legal Balance Sheet, including the total investment in subsidiaries. Secondly, that which lies behind the investment in the subsidiaries would be revealed by the consolidated statement of the assets and liabilities of the subsidiaries. Thirdly, the consolidation of the latter statement with the legal Balance Sheet of the holding company would reveal the overall financial position of the entire group of companies.

In the case of all of these consolidated statements, both as regards earnings and assets and liabilities, it is important to appreciate that they are statistical statements only, prepared for the benefit of the shareholders of the holding company. These statements are built up from the Profit and Loss Accounts and Balance Sheets of all of the companies within the group and they are not therefore the accounts of one business undertaking.

In preparing these statements you must also bear in mind that adjustments have to be made in the case of all of these consolidated statements for the interest of outside shareholders. The holding company is entitled to a proportion only of the aggregate earnings and of the surplus of assets over liabilities of the subsidiaries. That proportion is governed by the holding company's share of the equity of the respective companies.

In addition, of course, all items representing inter-company indebtedness should cancel out. In those cases in which the financial years of the parent and subsidiaries do not coincide an adjustment has, of course, to be made.

In order to illustrate a method of presentation of the accounts of a holding company international in character, and with a view to illustrating the main points we are considering, I shall now turn to the 1933 accounts of my company.

In the first place I desire to make a few remarks upon the broad basis of the report and accounts.

You will observe that the directors' report is much fuller and more informative than is usual in this country. In the case of the profit figures and also the Balance Sheet position, comparisions with the figures for the previous year are given with explanations as to the principal variations. In this way the Board endeavours to read the accounts for the benefit of the shareholders, and to give a general report on the year's operations.

This procedure has a practical advantage, as it relieves the chairman's speech at the annual meeting of a considerable burden of detail figures and leaves him free to deal with the major matters and questions of general policy.

You will all have seen many directors' reports that contain merely a statement as to the profits available and the recommended appropriations, together with the names of the directors due to retire by rotation and that they and the auditors offer themselves for re-appointment. It always seems to me that a board should have more than this to say in its annual report to the shareholders. There is no question to my mind but that the directors' report can most helpfully be used to amplify and clarify for the benefit of the shareholders the information contained in the accounts themselves and the development of this practice is worthy of the consideration of the boards of public companies.

Turning to the Balance Sheet (see pages 78 to 81) you will observe that the items are grouped and that sub-totals are given. This simple innovation greatly facilitates the reading of a Balance Sheet. For example the ratio of current liabilities to current assets and other important ratios can be seen at a glance. If you set out the figures of the Balance Sheet before you in the old-fashioned way in two straight columns you will see how the picture is immediately blurred. The grouping in this way of items in a Balance Sheet seems to me to be so obviously helpful that I am surprised to see so many Balance Sheets still published in the old conventional manner.

You will observe also that the figures for the preceding year are given, which enables the variations to be readily seen. In the accounts before you the figures for the preceding year do not appear on the consolidated statement, as 1933 was the first year in respect of which these statements were published. The inclusion of the figures for the preceding year is a practice that in my experience is much appreciated both by shareholders and the financial press, as it greatly facilitates the reading of the accounts.

You will also have noticed that we show the figures to the nearest £. This is done merely with a view to making the statements easier to read. Some of you may have read recent correspondence in *The Accountant* adversely criticizing this practice. You will appreciate that the actual accounts on our files contain the shillings and pence and that it is

merely when printing these documents for publication that we are so bold and unorthodox as to delete the shillings and pence.

Under the heading of current liabilities and provisions in the Balance Sheet and also in the Profit and Loss Account we include the proposed dividends and we also include all dividends in the accounts after deduction of income tax, and not gross, as no doubt you have all been taught to do. Both of these methods are unorthodox and contrary to all accountancy textbooks in this country except one, which is under my evil influence, and I would warn those of you who have examinations before you against preparing accounts in this way in the examination room. I must confess to have been the originator of these heretical ideas, but the "disease" has spread and to-day there are many public companies that adopt one or other or both of these ideas in the preparation of their accounts, with, I respectfully suggest, nothing but helpfulness to those to whom they are submitted.

As regards the inclusion of proposed dividends, I fully appreciate the theoretical arguments against this practice, but accounts, I suggest, are prepared for a practical purpose and not to satisfy the minds of accountancy purists. Let us guard against becoming the slaves of theory!

If, as is the generally accepted practice, the proposed dividends are not included, then in effect we take two bites at our cherry. We present a Balance Sheet which shows a position that is immediately and fundamentally altered as soon as the dividends recommended by the board are declared. Those dividends have to be provided for out of the current assets of the company; if, therefore, these dividends are not included in the Balance Sheet the shareholders will not obtain a clear view as to the effect the proposed distribution will have upon the surplus of current assets over current liabilities. For example, if you will refer to the Dunlop Rubber Co.'s Balance Sheet (page 80) you will see that the proposed dividends amount to over £600,000, which obviously has a considerable bearing upon the liquid position.

In my opinion, therefore, it greatly facilitates the reading of the accounts if the proposed dividends are included, and this practice has been warmly approved by the financial press, including *The Accountant*. I agree that this procedure runs counter to accepted theory, but personally I am prepared to sacrifice theoretical principles upon the altar of practical expediency. Accounts are prepared for laymen to read and in my opinion everything should be done to make these documents as clear and simple to understand as possible, and with this end in view I am willing unblushingly to depart from accepted theory. In this connection you will have noticed that two very eminent firms of Chartered Accountants have passed our Balance Sheet as being correct, in spite of these apparent theoretical transgressions.

I now propose to consider each of the statements in the accounts before you with a view to illustrating a form of presentation of the

accounts of a holding company which is in some directions a departure from general practice.

STATEMENT OF PROFITS

(See page 77)

In my opinion, this statement represents the most interesting feature of these accounts and answers some of the most vexed questions that arise in connection with the accounts of holding companies.

You will observe that *Item I* represents the aggregate profits for the year of the parent company, including its proportion of the profits, less losses, of all subsidiary and sub-subsidiary companies, but before providing for payments in respect of guaranteed preference dividends.

This figure therefore represents the normal earnings of the whole group of companies for the year, after adjustment for minority interests. The total profits thus shown can therefore be related to the total capital employed in the whole combine as shown by the consolidated statement of assets and liabilities (pages 84 and 85) and thus on the one hand the earnings can be judged and on the other hand the reasonableness or otherwise of the figures at which the combined assets stand.

Item II is, I think, of special interest. You will observe that it represents the main company's proportion of items which do not represent normal earnings attributable to the current year. In a large group of companies there are from time to time inevitably "windfalls," but under this form of presentation such items are clearly separated from the normal earnings. Further, if subsidiary companies were to declare dividends out of past profits, such dividends would come under this heading as representing abnormal items. In this way, therefore, if past reserves are drawn upon or credit is taken for any other abnormal items, this fact and the aggregate amount involved is clearly stated.

You will observe that the statement then gives particulars (*Item IV* (*a*)–(*d*)) of the amounts deducted from the earnings of subsidiary and sub-subsidiary companies in respect of British and foreign taxation and guaranteed preference dividends.

Item IV (*e*) is another item of special interest, as it shows the total amount of the profits of subsidiaries held back during the year by those companies by way of special appropriations and undistributed profits held in reserve. If, therefore, undistributed profits were accumulated in the hands of subsidiaries this fact and the aggregate amount involved are clearly stated.

Item V represents the balance of profits available to the parent company and agrees with its Profit and Loss Account (pages 82 and 83). The remainder of this statement does not, I think, call for special comment.

This statement, I think you will agree, is a very simple one, but it does, I suggest, give a clear view of the aggregate earnings of the

combine as a whole and of the holding company itself. Further, it clearly separates normal and abnormal earnings and shows the amount of undistributed profits of subsidiaries and special appropriations that are being retained by those companies. You will observe also that this statement embraces sub-subsidiary companies to which, by a curious omission, the Companies Act does not refer, and although the law apparently takes no cognizance of grandchildren from grandfather's point of view, anything in the nature of a portrait of the family group cannot reasonably exclude these not infrequently numerous descendants.

Profit and Loss Account
(See pages 82 and 83)

There are no special features in connection with the Profit and Loss Account of the holding company itself, except that here again abnormal items are shown separately and as I have already stated the proposed dividends are included.

Upon reflection I hope you will come to the conclusion that this form of presentation of the earnings in the two statements we have considered does answer the various points of difficulty in connection with holding companies that I have already described. In any event, it does represent an honest attempt to solve those problems.

Balance Sheet of the Holding Company
(See pages 78 to 81)

As regards the Balance Sheet of the holding company itself, I have already dealt with the main features, but there are just two points to which I should like to refer.

Amongst the reserves (*Item II* (*d*)) you will observe an item "reserves for inter-company profits in inventory valuations of subsidiary companies." As we have seen, in the case of a holding company, it is highly desirable to make adjustment for inter-company profits of this nature, but I have never before seen the item separately and distinctly stated. I suggest that there is an advantage in doing this, as it makes it clear that these adjustments have in fact been made.

You will also note that the reserve for contingencies (*Item II* (*c*)) is separately stated. It is not uncommon in published Balance Sheets for an item of this character to be merged with sundry creditors, but I am of the opinion that, with the possible exception of banks, which are in a category by themselves, all items of this nature should be disclosed.

Consolidated Statement of Assets and Liabilities
(See pages 84 and 85)

By way of preface to my remarks under this heading I should like to take this opportunity of expressing the opinion that the term "consolidated Balance Sheet," which is so frequently used, is a misnomer. There can, in my view, strictly speaking, be no such thing.

The term "Balance Sheet" implies a picture of the financial position of *a* company—*a* firm, *an* individual, *an* institution—in other words a self-contained unit or entity—and the moment you travel beyond the limits of that unit and seek to conglomerate a series of such pictures the result, if you think it out, can never be a Balance Sheet, but is nothing more than a consolidated statement of assets and liabilities, which you will observe is the title under which we have presented the picture of our family group.

The first feature to which I would direct your attention is the indication which is clearly given at the head of the statement as to the exact point at which consolidation has been effected, i.e. that the statement embraces all subsidiary and sub-subsidiary companies in which over 50 per cent of the ordinary shares or stock or over 50 per cent of the voting control is held within the group.

The exact point of consolidation is an interesting and debatable question. Some holding companies take the view that a 75 per cent holding should be the determining point, presumably on the ground that such a majority is necessary in order to gain effective control, having regard to the voting majority requisite for the passing of a special resolution.

I do not propose to discuss this question, but merely wish to point out that I have never before seen a statement which indicates specifically the precise point at which consolidation has been adopted.

This statement, which shows the financial position of the group of companies as a whole, follows substantially, so far as arrangement and grouping of items is concerned, the same lines as the legal Balance Sheet.

The object of this statement is to reveal what lies behind that large "umbrella" which the legal Balance Sheet shows "father" holding in his hand in the shape of investments in and advances to and from subsidiary companies and, read in conjunction with the statement of profits which reveals the aggregate earnings of the group as a whole, presents, I submit, a complete picture. Thus shareholders are enabled to obtain a reasonably clear view, both of the earnings and of the financial position of the group of companies in which, through their shares in the parent company, they are interested as investors.

This statement is, of course, made up from the Balance Sheets of all the companies within the group, in accordance with the definition at the head of the statement to which I have already referred.

The interest of outside shareholders, you will see, is separately stated on the left-hand side (*Item III*). In arriving at this figure there has been taken into account the outside shareholders' proportion of general reserves and undistributed profits or losses.

On the other side of the Balance Sheet the item goodwill accounts (*Item IV*) may puzzle some of you. Upon consolidation there may, of course, be items of goodwill in some of the various Balance Sheets.

In addition, when purchasing shares in subsidiary companies the holding company may have paid more or less than the par value for the shares, and in consequence adjustments in respect of these differences become necessary.

For example, suppose a case where a holding company purchased for a sum of £200,000 the whole of the issued share capital of another company consisting of 150,000 shares of £1 each. It happens that the Balance Sheet of the latter company discloses the following position—

	£		£
Share Capital	150,000	Goodwill	10,000
Creditors	130,000	Tangible Assets	290,000
Profit and Loss Account	20,000		
	£300,000		£300,000

Assume further that the purchase was effected on the day on which the holding company closed its accounts and that the newly acquired subsidiary is therefore coming into the consolidated statement we have to prepare.

In the first place there is the asset of £200,000 (the cost of the shares) appearing in the legal Balance Sheet of the holding company which is expunged from the consolidated statement in order that its place may be taken in the latter document by that which the investment represents, namely the assets less the liabilities of the subsidiary company.

There therefore comes into the consolidated statement the various tangible assets of the subsidiary which will be grouped under their appropriate headings—

	£	£
Totalling		290,000
There will also come in under the heading of goodwill the amount at which that asset stands in the subsidiary Balance Sheet, viz.	10,000	
We must now, however, face the fact that we had to pay a premium for these shares which is not represented by any specific asset in the subsidiary's accounts	50,000	
Thus we get for our consolidated statement a goodwill figure of	60,000	
Although, however, we paid this premium for the shares, there were undistributed profits in the subsidiary which we can abstract by way of dividend at once if we will, so that these profits should properly be deducted	20,000	
Leaving as the effective price we have paid for the goodwill of the subsidiary		40,000
The total we have accounted for on the assets side of the consolidated statement is thus		330,000
After inserting on the liabilities side of the statement the subsidiary company's creditors amounting to		130,000
There is left a difference of		£200,000

There is left a difference of £200,000 which, you will observe, is exactly equal to the cost of the investment appearing in the legal Balance Sheet.

In the case of a large international holding company the form of presentation of the accounts is a complex problem. It has first to be decided exactly what information should be given and then how it can best be presented. Our aim, I suggest, should be to give the shareholders all the information that they may reasonably expect in as clear and simple a form as is possible.

The argument is commonly put forward that it may be very hurtful to a holding company to publish consolidated statements of earnings and of assets and liabilities, on the ground that this information may be used by competitors to the detriment of the combine.

I find great difficulty in accepting this argument; in fact, upon the lines I have described, I cannot imagine how the information disclosed can be utilized by competitors to the detriment of a holding company.

I have been told that such disclosures may be harmless in good times, but that a holding company would regret such disclosure when bad times came. I do not agree. The directors of a company cannot always prevent a fall in profits or even losses. If in such circumstances the earnings of the combine suffer, surely the shareholders are entitled to see the real effect of the adverse trading conditions upon the company. Experience clearly shows that directors have got into serious difficulties only when they framed their accounts so as to withhold from the shareholders a true view of the position of affairs.

I venture the opinion that no holding company that has issued consolidated statements would testify that the company had suffered thereby in any way. Experience, I suggest, is all the other way, in that the publication of informative accounts tends to breed that confidence of shareholders and of the public generally which is of real commercial value to any undertaking.

The presentation of accounts with the obvious intention of withholding information is frequently the forerunner of rumour and ill-founded conjecture, which competitors may exploit to the detriment of a company.

My own view is that, both from the ethical and the commercial standpoint, full and informative accounts are, in the long run, the only wise policy.

There is no question that in the case of holding companies there has developed a strong public demand calling for more informative accounts, and to illustrate the public response to the issuing of consolidated statements, may I read you three extracts from the Press referring to the accounts you have before you to-night.

[*The three extracts referred to are given on page* 86].

DUNLOP RUBBER COMPANY, LTD.

Directors:

Chairman: The Rt. Honble. Sir ERIC GEDDES, G.C.B., G.B.E., K.C.B.

Managing Director: Sir J. GEORGE BEHARRELL, D.S.O.

CLIVE L. BAILLIEU, C.M.G.	Sir S. HARDMAN LEVER, Bart., K.C.B.
The Rt. Honble. LORD COLWYN, P.C.	C. A. PROCTOR.
Sir ALEXANDER GIBB, G.B.E., C.B.	F. ALEXANDER SZARVASY.

Secretary: CHARLES TENNYSON, C.M.G.

DIRECTORS' REPORT

The Directors submit the Balance Sheet as at 31st December, 1933, together with the Profit and Loss Account for the year 1933.

The Board, in presenting the Accounts of the Dunlop Rubber Company and its Subsidiaries in a new and improved form, desires to give fuller information to the shareholders, and it is believed that in addition to the ordinary Balance Sheet, etc., the Consolidated Statement of Assets and Liabilities and the Consolidated Statement of Earnings herewith submitted will be appreciated.

During 1933, trading conditions in this country showed a marked improvement, particularly in the case of the Motor and Cycle industries, but in many countries abroad conditions continue to be very unsettled and difficult. In these circumstances, the Board considers the results achieved by the Company during the past year to be highly satisfactory.

The net profit for the year of £1,512,866 compares with £860,077 for 1932, representing an increase of £652,789.

Trading Results.

From the Statement on page 83 it will be seen that the total available profits for appropriation amount to £1,955,073 9s. 5d.

The Directors appropriations and recommendations are as follows—	£	s.	d.
Transfer to Taxation Reserve	403,956	6	3
Transfer to General Reserve	200,000	0	0
Preference Dividends paid for the half-year to 30th June, 1933, *less* Income Tax at 5s. in the £	140,625	0	0
The Board proposes the payment of Dividends on the "A," "B," and "C" Cum. Preference Shares for the half-year to 31st December, 1933, *less* Income Tax at 4s. 6d. in the £, absorbing	145,312	10	0
The Board proposes the payment of a dividend on the Ordinary Stock of 8 per cent, *less* Income Tax at 4s. 6d. in the £ payable on the 26th May, absorbing	486,764	16	0
Balance carried forward to next account	578,414	17	2
	£1,955,073	9	5

During the year under review a profit on exchange was realized of £203,766, and this amount has been transferred to the credit of the reserve for contingencies which is referred to later in this Report.

The whole of the Guaranteed Preference Dividends in respect of Dunlop Cotton Mills, Ltd., and Dunlop Rubber Company (India), Ltd., have been met out of the profits of those Companies. As regards Dunlop Plantations, Ltd., £41,618 has been provided out of the profits of that Company, and the balance of £70,882 has been borne by the Dunlop Rubber Company under the terms of its guarantee, and has been charged against profits. This amount and the similar payments in previous years are repayable to this

Company out of any future profits of Dunlop Plantations, Ltd., but no credit for any such repayments has been taken in these accounts.

The Dunlop Rubber Company (India), Ltd., has repaid out of the profits of 1933, £16,966 on account of Preference Dividends paid by this Company in previous years. This amount has been credited to this Company's Profit and Loss Account for 1933.

In accordance with established practice, provision has been made in the accounts of this Company for its proportion of losses incurred during 1933 by any Subsidiary and Associated Companies that have incurred losses and the profits of Subsidiary Companies have been included in this Company's profits to the extent of dividends declared in respect of the year 1933.

BALANCE SHEET (pages 78 to 81).

The following statement shows in comparative form for 1932 and 1933 the Assets of the Company—

	1932	1933	*Decrease*
	£	£	£
Fixed Assets	4,469,356	4,244,610	*224,746*
Investments and Advances	13,522,712	13,014,396	*508,316*
Current Assets	7,263,986	4,954,143	*2,309,843*
	£25,256,054	22,213,149	*3,042,905*

Fixed Assets.—Adequate provision has been made for depreciation, and all Fixed Assets have been thoroughly maintained. In the case of plants that have been closed down under the scheme of reorganization, ample provision has been made for possible losses upon realization.

Investments and Advances.—During 1933 the Company acquired a holding of Ordinary Shares in the India Tyre and Rubber Company, Ltd., and advances have been made to certain Subsidiaries. On the other hand, under the scheme of reorganization certain Subsidiary Companies have been closed down or reconstructed, and two foreign Companies made substantial payments to this Company in reduction of their Loan Accounts. The net effect of these transactions is a decrease of £508,316 in Investments and Advances.

Current Assets.—The Redemption of Debentures and Mortgage is naturally reflected in a decrease of Current Assets, but although these redemptions during 1933 amounted to £3,461,306, the Current Assets have decreased by only £2,309,843, and the Liquid Assets, i.e. Bills Receivable, Government and other Securities, Accrued Interest and Bank Balances, amounted at the 31st December last to £2,215,168.

The Redemption and Conversion of Debentures and Repayment of Mortgage will result in an annual saving of £227,700, compared with 1932.

The Capital and Liabilities are as follows—

	1932	1933	Increase *Decrease*
	£	£	£
Share Capital	12,251,045	12,251,045	—
Surplus and Reserves	4,226,902	4,346,887	119,985
	£16,477,947	16,597,932	119,985
Debentures and Mortgage	5,802,277	2,340,971	*3,461,306*
Amounts owing to Subsidiary and Associated Companies	1,652,247	1,513,659	*138,588*
Current Liabilities and Provisions	1,323,583	1,760,587	437,004
	£25,256,054	22,213,149	*3,042,905*

Surplus and Reserves.—The premium on the redemption of the 1st Debenture Stock and the costs of the new issue amounted to £292,137, and the Board has decided to write this amount off against the General Reserve. The Board has also decided to transfer to the General Reserve £200,000 out of available profits.

In the past a Reserve for Obsolescence was deducted from the item Shares in Subsidiaries. After writing off against this Reserve losses arising in connection with Subsidiary Companies closed down, the Directors have transferred the balance remaining to a Reserve for Contingencies, and to this Reserve there has been added, as stated above, the realized profits on exchange of £203,766. The Reserves for Contingencies now amount to £643,260, compared with £539,376, as stated by the Chairman in his speech last year.

Throughout the organization the inventories have been conservatively valued as in preceding years. The Company has pursued its established policy of only purchasing raw materials for its normal requirements. The inventories held and contracted for at the 31st December, 1933, were purchased at favourable prices.

In the case of all Companies, a very ample provision has been made for bad and doubtful debts, and every known loss at home and abroad has been provided for in the accounts.

The Director due to retire by rotation is Mr. C. L. Baillieu, and he offers himself for re-election.

The Auditors, Messrs. Stokes Bros. and Pim, and Messrs. Whinney, Smith and Whinney, retire, and being eligible, offer themselves for re-appointment.

By Order of the Board,

ERIC GEDDES, *Chairman.*
J. GEORGE BEHARRELL, *Managing Director.*
C. TENNYSON, *Secretary.*

5th May, 1934.

STATEMENT OF PROFITS for the year 1933

	£	£
I. THE AGGREGATE PROFITS OF THE DUNLOP RUBBER CO., LTD., for the year 1933, including its proportion of the profits *less* losses of all Subsidiary and Sub-subsidiary Companies after providing for Depreciation, etc., but before providing for guaranteed Preference Dividends of Subsidiary Companies amount to		2,255,973
II. IN ADDITION, the Dunlop Rubber Company's proportion of various items which do not represent normal earnings attributable to the current year, amounts to		90,671
III. AGGREGATE TOTAL		2,346,644
IV. FROM THE RESULTS OF SUBSIDIARY AND SUB-SUBSIDIARY COMPANIES INCLUDED ABOVE THERE HAS BEEN DEDUCTED—		
(*a*) The Dunlop Rubber Company's proportion of British and Foreign Taxation paid by or provided in the accounts of such companies .	229,440	
(*b*) The payment on account of the Guaranteed Preference Dividend of Dunlop Plantations, Ltd., for the year to 30th November, 1933, made by that Company	41,618	
(*c*) The whole of the Guaranteed Preference Dividend of Dunlop Cotton Mills, Ltd., for the year to 31st January, 1934, paid by that Company .	109,687	
(*d*) The whole of the Guaranteed Preference Dividend of Dunlop Rubber Co. (India), Ltd., for the year to 31st December, 1933, paid by that Company	13,554	
(*e*) The Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve	83,421	
		477,720
V. BALANCE AVAILABLE TO THE DUNLOP RUBBER CO., LTD., as per that Company's Profit and Loss Account (pages 82 & 83)		1,868,924
VI. DEDUCT: (*a*) Guaranteed Preference Dividends of Subsidiary Companies borne by the Dunlop Rubber Co., Ltd.—		
Balance in respect of Dunlop Plantations, Ltd.	70,882	
(*b*) Interest on Debentures and Loans .	285,176	
		356,058
VII. LEAVING THE NET PROFIT AS PER THE DUNLOP RUBBER COMPANY'S PROFIT AND LOSS ACCOUNT (pages 82 & 83)		1,512,866
VIII. *Add* Balance brought forward from last year . .		442,208
IX. TOTAL AVAILABLE		£1,955,074

DUNLOP RUBBER
BALANCE SHEET AS AT

1932 £		Authorized Shares & Stock £	Issued Shares & Stock £	£
	I. SHARE CAPITAL—			
	1,000,000 6½% "A" Cum. Pref. Shares of £1 each	1,000,000	1,000,000	
	1,000,000 7% "B" Cum. Pref. Shares of £1 each	1,000,000	1,000,000	
	3,000,000 10% "C" Cum. Pref. Shares of 16/- each	2,400,000	2,400,000	
	£15,600,000 Ordinary Stock	15,600,000	7,851,045	
12,251,045				12,251,045
		£20,000,000		
	II. SURPLUS AND RESERVES—			
	(a) General Reserve (including balance of Share Premium Account)			
	Balance at 31st December, 1932		1,216,980	
	Less Premium and Compensations on redemption of 1st Debenture Stock and Costs of new issue		292,137	
			924,843	
	Add Transfer from Profit and Loss Account (page 82)		200,000	
1,216,980			1,124,843	
2,000,000	(b) Special Reserve—against investments in and advances to Subsidiary Companies		2,000,000	
539,376	(c) Reserves for Contingencies		643,260	
28,338	(d) Reserve for Inter-Company Profits in Inventory Valuations of Subsidiary Companies		369	
442,208	(e) Surplus, i.e. Profit and Loss Account Balance after providing for proposed dividends as per Profit and Loss Account (pages 82 & 83)		578,415	
4,226,902				4,346,887
16,477,947				16,597,932
	III. DEBENTURES AND MORTGAGES secured upon assets of the Company—			
	(a) First Mortgage 5½% Debenture Stock	£5,000,000		
4,366,987	*Less* Redeemed and cancelled to date	4,715,250	284,750	
	(b) Second Mortgage 6% Debentures	2,000,000		
1,295,290	*Less* Redeemed and cancelled to date	2,000,000	—	
	(c) 4% Debenture Stock (Authorized £3,500,000)	2,620,200		
	Less uncalled	563,979	2,056,221	
140,000	(d) Mortgage	140,000		
	Less Redeemed to date	140,000	—	
5,802,277				2,340,971
22,280,224	*Carried forward*			18,938,903

COMPANY, LIMITED

31st December, 1933

1932 £		£	£
	I. FIXED ASSETS at Cost, *less* Realizations and Depreciation—		
1,948,067	(a) Freehold Land and Buildings . .	1,884,801	
424,843	(b) Leasehold Premises	401,043	
1,295,222	(c) Plant, Machinery, Tools, and Moulds .	1,164,050	
151,681	(d) Furniture, Fittings, and Fixtures . .	145,187	
8,979	(e) Cars and Delivery Vans . . .	8,965	
640,564	(f) Patents, Trade Marks, Licences, and Royalty Agreements as valued by the Directors at 31st December, 1926, *plus* additions at cost, *less* amounts written off	640,564	
4,469,356			4,244,610
	II. INVESTMENTS AND ADVANCES at Cost, *less* amounts written off and Reserves		
	Subsidiary Companies:		
4,960,847	(a) Shares.	4,932,478	
196,593	(b) Debentures	196,593	
7,159,116	(c) Advances and Current Accounts (including dividends since declared) . .	6,686,425	
12,316,556	(In respect of this amount an allocation of £2,000,000 to Special Reserve was made in 1931, as *per contra*)	11,815,496	
	Associated Companies:		
930,626	(d) Shares.	977,087	
179,363	(e) Advances and Current Accounts (including dividends since declared) . .	114,225	
	Sundry Investments:		
73,823	(f) In hands of Trustees for Debenture Holders: British Government Securities at Cost. . . . . . 73,823 (Market Value at 31st December, 1933, £80,202)		
3,083	Cash 15,442	89,265	
19,261	(g) Trade Investments	18,323	
13,522,712			13,014,396
17,992,068	*Carried forward*		17,259,006

1932 £		£	£
22,280,224		*Brought forward*	18,938,903
	IV. AMOUNTS OWING TO SUBSIDIARY AND ASSOCIATED COMPANIES— (*Less* Dividends since declared)		
	(*a*) Subsidiary Companies	1,473,543	
	Less Company's own Debenture Stock included therein . .	11,028	
1,601,423		1,462,515	
50,824	(*b*) Associated Companies	51,144	
			1,513,659
1,652,247			
	V. CURRENT LIABILITIES AND PROVISIONS—		
477,427	(*a*) Sundry Creditors, including accrued Debenture and Mortgage interest . .	545,010	
	(*b*) Proposed Dividends—		
140,625	Preference Dividends for half-year to 31st December, 1933, *less* Income Tax	145,312	
235,531	Ordinary Dividend for the year to 31st December, 1933, *less* Income Tax .	486,765	
470,000	(*c*) Taxation Reserve.	583,500	
1,323,583			1,760,587
£25,256,054			£22,213,149

Report of the Auditors to the Members of the Dunlop Rubber Company, Limited.

In accordance with the provisions of Section 134, sub-section 1, of the Companies Act, 1929, we report as follows—

We have audited the above Balance Sheet with the books of the Company in which have been incorporated the Returns from Branches certified by Local Auditors or the Branch Officials, and we have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company and the said Returns.—London, 28th *April*, 1934.

1932 £		£	£
17,992,068	*Brought forward*		17,259,006
	III. CURRENT ASSETS—		
1,817,322	(*a*) Inventories of finished and unfinished goods, raw materials, and stores, etc., at or below cost as certified by the Company's Officials	1,868,590	
834,944	(*b*) Sundry Debtors, *less* Reserves	817,775	
22,400	(*c*) Leasehold Redemption Policy	26,133	
55,214	(*d*) Bills Receivable	85,639	
977,332	(*e*) British Government Securities at Cost (Market Value at 31st December, 1933, £7,594)	7,603	
281,691	(*f*) Other Securities	19,097	
11,061	(*g*) Accrued Interest	5,597	
3,245,225	(*h*) Bank Balances, Deposits, Cash in hand and in Transit	2,097,232	
18,797	(*i*) Deferred Charges	26,477	
7,263,986			4,954,143

NOTE.—The Company has guaranteed the Preference Shares of Dunlop Cotton Mills Ltd., Dunlop Plantations, Ltd., and Dunlop Rubber Co. (India) Ltd., as regards Capital, Premium and Dividends, and is also contingently liable in respect of the guarantee of Bank advances to certain Subsidiary Companies.

£25,256,054	£22,213,149

STOKES BROS. & PIM,
WHINNEY, SMITH & WHINNEY, } *Auditors.*
Chartered Accountants.

ERIC GEDDES, *Chairman.*
J. GEORGE BEHARRELL, *Managing Director.*
C. TENNYSON, *Secretary.*

DUNLOP RUBBER

Dr. **PROFIT AND LOSS ACCOUNT**

1932 £				£
361,304	I.	To Depreciation, etc.		355,932
200,000	II.	„ Obsolescence Reserve		—
8,000	III.	„ Directors' Fees		8,000
1,353,064	IV.	„ Balance carried down		1,868,924
1,922,368				£2,232,856
	V.	To Guaranteed Preference Dividends:		
106,884		(*a*) Part in respect of Dunlop Plantations, Ltd.	70,882	
13,500		(*b*) The whole in respect of Dunlop Rubber Co. (India), Ltd.	—	
120,384				70,882
372,603	VI.	„ Interest on Debentures and Loans		285,176
860,077	VII.	„ Net Profit carried down		1,512,866
1,353,064				£1,868,924
292,947	VIII.	To Transfer to Taxation Reserve		403,957
—	IX.	„ Transfer to General Reserve		200,000
	X.	„ Preference Dividends:		
140,625		(*a*) Half-year to 30th June, 1933 (already paid), *less* Income Tax at 5/– in the £	140,625	
140,625		(*b*) Proposed for the half-year to 31st December, 1933, *less* Income Tax at 4/6 in the £	145,312	
				285,937
	XI.	„ Ordinary Dividend:		
235,531		Proposed for the year to 31st December, 1933, *less* Income Tax at 4/6 in the £		486,765
442,208	XII.	„ Balance carried forward as per Balance Sheet		578,415
£1,251,936				£1,955,074

COMPANY, LIMITED

for the year ended 31st December, 1933 Cr.

1932 £		
1,922,368	I. By Profit on Trading, Interest, Dividends on Investments, including those received from or since declared by Subsidiary and Associated Companies, and Miscellaneous Receipts . . .	2,215,890
—	II. „ Repayment by Dunlop Rubber Co. (India), Ltd., on account of Guaranteed Preference Dividends paid by the Dunlop Rubber Co., Ltd., in previous years	16,966
1,922,368		£2,232,856
1,353,064	III. By Balance brought down	1,868,924
1,353,064		£1,868,924
860,077	IV. By Net Profit brought down	1,512,866
391,859	„ Balance brought forward from 1932 . . .	442,208
£1,251,936		£1,955,074

NOTE.—The Profits of Subsidiary Companies are included in the profits of this Company to the extent of the dividends declared in respect of the year 1933.
In the case of those Subsidiary Companies which have sustained losses this Company's proportion thereof has been provided for out of the profits as above set forth with the exception of certain losses of a capital nature which have been charged against the Reserve for Contingencies. In the accounts of the Subsidiary Companies these losses have been either carried forward or provided for out of undistributed profits of those Companies.

ERIC GEDDES
J. GEORGE BEHARRELL } *Directors*

CONSOLIDATED STATEMENT OF ASSETS

DUNLOP RUBBER COMPANY LIMITED

Incorporating the figures of the audited Balance Sheets (after elimination of inter-company Companies in which the Dunlop Rubber Company Limited and any of its Subsidiaries hold

		£	£
I. ISSUED SHARE CAPITAL OF THE DUNLOP RUBBER COMPANY, LIMITED—			
1,000,000 6½% "A" Cumulative Preference Shares of £1 each fully paid		1,000,000	
1,000,000 7% "B" Cumulative Preference Shares of £1 each fully paid		1,000,000	
3,000,000 10% "C" Cumulative Preference Shares of 16/- each fully paid		2,400,000	
£7,851,045 6/8 Ordinary Stock		7,851,045	
			12,251,045
II. SURPLUS AND RESERVES—			
(a) General Reserves		1,309,668	
(b) Special Reserve in the accounts of the Dunlop Rubber Company, Limited, in respect of Subsidiary Companies		2,000,000	
(c) Reserves for Contingencies		643,260	
(d) Surplus, i.e. Profit and Loss Account Credit Balances		661,943	
			4,614,871
			16,865,916
III. INTEREST OF OUTSIDE SHAREHOLDERS— Preference and Ordinary Share Capital of Subsidiaries held by Outside Shareholders, after taking into account their proportion of General Reserves and Undistributed Profits or Losses attributable thereto			6,153,496
IV. DEBENTURES, MORTGAGES, AND LOANS—			
(a) Dunlop Rubber Company Limited, Debenture Stock	2,340,971		
Less: Held by Subsidiary Company	11,028		
		2,329,943	
(b) Loans		785,941	
(c) Mortgages		10,000	
			3,125,884
V. CURRENT LIABILITIES AND PROVISIONS—			
(a) Sundry Creditors and Accrued Charges		1,647,382	
(b) Amounts owing to Associated Companies		51,144	
(c) Taxation Reserves		864,439	
(d) Proposed Dividends—			
Dunlop Rubber Company Limited, Dividends		632,077	
Dividends of Subsidiaries to Outside Shareholders		74,632	
			3,269,674
VI. SUSPENSE ACCOUNT for transactions with Subsidiary Companies between the dates of their Balance Sheets and 31st December, 1933			1,284
VII. EXCHANGE SUSPENSE ACCOUNTS, BEING AMOUNTS RESERVED FOR UNREALIZED EXCHANGE DIFFERENCES			4,371
			£29,420,625

We have examined the above Consolidated Statement of Assets and Liabilities with the Balance Sheet of the Dunlop Rubber Co., Ltd., at 31st December, 1933, as audited by us, and with the Balance Sheets of the Subsidiary and Sub-subsidiary Companies, as audited by their respective auditors. In the case of certain Subsidiary Companies, the Balance Sheets are at dates other than 31st December, 1933, and the adjustments consequent thereon have been made. In our opinion, the statement set forth above has been correctly compiled from the said Balance Sheets, after giving effect to necessary adjustments in respect of Foreign Exchange, so as to exhibit a true and correct view of the consolidated position of the Companies at 31st December, 1933.—London, 25th *April*, 1934.

AND LIABILITIES as at 31st December, 1933

AND SUBSIDIARY COMPANIES

balances) of the Dunlop Rubber Company Limited and all Subsidiary and sub-Subsidiary over 50% of the Ordinary Shares or Stock of those companies or over 50% of the voting control.

	£	£
I. FIXED ASSETS, at cost *less* realizations and provisions for depreciation and obsolescence—		
(a) Land, Factory and other Buildings, Cotton Mills, Plant, Tools, Furniture, Cars, etc.	10,716,376	
(b) Dunlop Plantations, Ltd., Estates, Buildings, Plant, etc.	4,207,677	
(c) Patents, Trade Marks, Licences, etc.	640,564	
		15,564,617
II. INVESTMENTS, at Cost *less* amounts written off—		
(a) Investments in Associated Companies	977,087	
(b) British Government Securities at Cost, and Cash in hands of Trustees for Debenture Holders	89,265	
(c) Trade and Sundry Investments	129,285	
		1,195,637
III. CURRENT ASSETS—		
(a) Inventories at or below cost	5,278,893	
(b) Sundry Debtors, Bills Receivable, etc., *less* Reserves	2,995,766	
(c) Amounts owing by Associated Companies	114,225	
(d) British and Canadian Government Securities (market value at 31st December, 1933, £134,544)	134,021	
(e) Other Securities	54,675	
(f) Bank Balances and Cash	2,668,341	
(g) Deferred Charges	90,787	
		11,336,708
IV. GOODWILL ACCOUNTS, including the difference between the values at which inter-company holdings of shares are taken as assets into the Balance Sheets and their Par Values, *less* undistributed profits at the date of the acquisition of such shares		1,323,663
		£29,420,625

STOKES BROS. & PIM,
WHINNEY, SMITH & WHINNEY, } *Auditors.*
Chartered Accountants.

ERIC GEDDES, *Chairman.*
J. GEORGE BEHARRELL, *Managing Director.*
C. TENNYSON, *Secretary.*

The Economist. "The report of the Dunlop Rubber Co. for 1933 places the company in the forefront of British concerns as regards the publication of clear, detailed and comprehensive accounts. The document embodies nearly all that *The Economist* and other critics of obscurantism have advocated, in season and out of season, for years past, and gives the lie to the familiar assertion that a large holding company cannot afford to go beyond the meagre disclosure laid down by law, for fear of giving away valuable information to its competitors."

The Accountant. "It is almost impossible to find sufficient praise with which to acclaim the new standard in company accounting set up by the 1933 accounts of the Dunlop Rubber Co. Ltd. Our best commendation is really their appearance in this week's issue of *The Accountant*, so that the accountancy profession itself may see the high level of informativeness that is possible in company accounts, particularly in the case of holding companies, if the determination of the management and officials is directed towards that end. These accounts answer all that the present-day criticism regarding the obscurity that is possible in the earnings and assets of subsidiary companies when accounts are presented in the manner allowed by law. Especially do they cover those points such as the holding up of profits in the accounts of subsidiaries and the accumulation of secret reserves and the subsequent declaration of dividends by subsidiaries wholly or partly out of profits of previous years."

The Daily Telegraph. "The 1933 accounts of the Dunlop Rubber Co. will be a joy to its own shareholders and the envy of all others. . . . Detailed Balance Sheets, classification according to liquidity, comparative figures, and even 'consolidated' statements are now, happily, familiar features of many accounts, though in all these improvements Dunlop has led the way. But no other company has yet had the courage so far to break with tradition as to give what may be called a 'consolidated' Profit and Loss Account, revealing the precise treatment of all subsidiary earnings and segregating all special credits; or to state plainly that all reserves are now disclosed. All these details now appear, and in the most unambiguous terms, with comparative figures in each case. The shareholder can hardly ask for more. It is no doubt too much to hope that all holding companies will speedily follow the Dunlop example, but now that tradition has once been broken, it is probable that really frank inter-company statements will become more and more common. If so, Dunlop will earn the lasting gratitude of all discerning investors."

These and similar comments in the Press in many parts of the world have encouraged my company to feel that it is upon the right course, and we are of the belief that through the new form of presentation of its accounts the company has lost nothing but gained much.

Chapter VI

The Form of Presentation of the Accounts of Holding Companies—(*contd.*)

An address delivered at a luncheon of the Birmingham and District Society of Chartered Accountants on 8th February, 1939.

AFTER stressing that he intended the address to be quite an informal one, Mr. de Paula said they would all realize that, whatever might be the advantages or disadvantages of holding companies, they did present or create accounting problems of considerable difficulty and complexity, in particular as to the form of presentation of those accounts. This was a problem which had been increasingly exercising the mind of the professional and commercial world, because holding companies were a form of organization which had undoubtedly been improperly used on occasions as a cloak to hide from shareholders the true position of the combine in which they were interested. There had been grave abuses and spectacular crashes which had shaken public confidence, and the subject had therefore loomed large in recent years.

Mr. de Paula said for the purpose of illustration he proposed to use the accounts of the Dunlop Rubber Company, which are reproduced on pages 92–109. He did not put these forward as a solution of the problem, but it was an attempt to solve it.

"In the first place, in tackling this problem," Mr. de Paula continued, "it is very necessary to keep clearly in our minds that every one of the companies within the group, including the holding company and the subsidiaries and sub-subsidiaries, are separate legal entities, each is a self-contained unit. A creditor has a claim only against the company to whom he gave credit, and there is no call upon the holding company to pay the creditors of a subsidiary.

The connection between the companies is by means of share investments and advances. In addition to subsidiaries there may be associated companies, that is to say those companies in which the holding company has only a fifty per cent or less interest."

The Companies Act of 1929 had various regulations dealing with holding companies. As regards Section 126, he said that the wording was vague, and he agreed with the late Sir Albert Wyon, who expressed the opinion that the effect of this section of the Act ". . . may indeed have the unintended effect of providing justification for directors who wish so to prepare the accounts of the holding company as to conceal from those chiefly interested the actual results of its activities."

"The true test of the value of any commercial enterprise is its capacity to earn profits, and what we want to be able to see is the trend

of earnings and their relationship to the capital invested in that undertaking. To be able to obtain, in the case of a holding company, some reasonably clear view of the earnings of the group is in my mind far more important than the popular demand for so-called consolidated Balance Sheets."

Limitations of the Legal Profit and Loss Account

The legal Profit and Loss Account of the holding company itself had, of course, distinct limitations and could give a most incomplete view of the position of the earnings of the group. The holding company could quite legally and properly take credit for the dividends declared or to be declared by profitable subsidiaries, but the holding company need not provide for the losses of the unprofitable subsidiaries. While that was the case the Profit and Loss Account of the holding company would give no indication of the earnings of the group. Further, if the subsidiary companies were making large profits, it was quite in order for small dividends to be paid by the subsidiaries, so that there were large accumulated profits which, when times were bad, could, as dividends, go into the holding company's accounts, despite the fact that they represented profits accumulated in previous years and were not profits earned during the year covered by the accounts.

A Proper View of Earnings

After the Kylsant case there had been a widespread feeling that shareholders in holding companies should be able to see what the normal earnings for the year were, and if there were abnormal items they should be stated separately.

There were two alternative ways of handling the position. One suggestion was that holding companies should take credit for the whole of the profits of the subsidiaries, not only what was distributed but also the undistributed profits of the year. That rather fouled the legal position which he had mentioned at the beginning, because the subsidiaries were not branches of the holding company and those undistributed profits might never become available for distribution, because they might be absorbed by subsequent losses. Further, those undistributed profits could not be available for distribution by the holding company itself, and if credit were taken for them it would be necessary to set up on the other side a reserve of equal amount to cancel the item out.

If that method were adopted it was possible to get a reasonably clear view of the earnings of the group, but it did not quite satisfy the speaker's mind, because it did not correspond with the legal position. Another alternative repeatedly put forward, but with which he disagreed, was that holding companies should send with their own accounts to shareholders the accounts of all subsidiary companies. If there were only two or three subsidiaries, this was possible, but one large holding

company had at one time eight hundred subsidiaries, and to-day had three hundred, while seventy or eighty subsidiaries were involved in the accounts they were considering at the moment. Even apart from the prospect of sending three hundred Balance Sheets to shareholders, in cases where there were only one or two subsidiaries merely to have the accounts was not of much advantage unless the shareholder knew what was the holding company's share in the equity of each subsidiary, and what were the trading arrangements between that company and the others within the group. Otherwise, without this information, quite erroneous conclusions might be reached from a study of the accounts. In conclusion, he said, that it was quite impossible to get any idea of the financial position of the group from the legal Balance Sheet of a holding company.

Looking at the Dunlop Company's legal Balance Sheet, Mr. de Paula went on, it would be seen that something over £15,000,000 was represented by investments in and advances to subsidiary and associated companies. That figure, as it stood, did not give any indication of the real value of those holdings.

The Dunlop Company's Accounts

It was owing to the limitations of the legal Profit and Loss Account and the legal Balance Sheet of a holding company that the demand for consolidated statements had been growing with increasing force. To follow this method effectively, however, it was necessary to have first the consolidated earnings of the group, and secondly the financial position of the group. It was also important to bear in mind that both of those statements were statistical. The problem was how to present them so that a reasonably clear picture of the position was given.

The Directors' Report

Mr. de Paula said it would be seen that the directors' report of the Dunlop Company was a much fuller one than was customary in this country.

It always seemed to him that a directors' report ought to have more to say than it commonly did, and he suggested that it should be used as a vehicle for explaining the accounts for the benefit of the shareholders, as the Dunlop directors' report endeavoured to do.

Grouping of Items

Then, turning to the Balance Sheet, they saw that the items were grouped—a method which had always seemed to have obvious advantages, and yet which was not adopted in many Balance Sheets. The company also gave the figures for previous years, and they had taken another revolutionary step in omitting shillings and pence, to make the balance clearer and easier to read. Another unorthodox item included was the proposed dividends.

Statement of Profits

The most interesting feature of the accounts they were considering, Mr. de Paula continued, was the statement of profits. The first item was the aggregate profits of the Dunlop Rubber Company, including its proportion of the profits less losses of all subsidiary and sub-subsidiary companies after providing for depreciation, but before providing for guaranteed preference dividends. That clearly gave the whole of the group's profits less losses for that year, and represented the normal earnings of the group. Then the next item—he thought his company were the first to be brave enough to include it—was the company's proportion of various items which did not represent normal earnings attributable to the current year. He did not think that in fact they had been very brave, as if a windfall for a substantial amount were received and was not disclosed in the accounts, the auditors of a holding company would, in all probability, insist on this fact being made clear either by the directors or in the auditor's report.

From this consolidated statement it was possible to see the relationship of the aggregate earnings of the group with the total capital invested in the group, and this comparison was therefore a cross-check on the valuation of the net assets shown in the consolidated statement of assets and liabilities.

The statement of profits included amounts deducted from the results of subsidiary companies, a specially interesting item being the Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve. The inclusion of this made it possible to see exactly what, if any, profits the subsidiary companies were holding back, and they could not therefore accumulate large undisclosed reserves. If profits in a subsidiary were accumulated and distributed subsequently as dividends, such a dividend would be included in the item representing abnormal earnings.

The statement of profits, he suggested, was an extremely simple one, and did give a reasonably clear view of the earnings of the group and then of the holding company itself.

Turning to the legal Profit and Loss Account of the holding company, Mr. de Paula pointed out that here also on the credit side the abnormal items were shown separately.

Consolidated Statement of Assets and Liabilities

Turning to the consolidated statement of assets and liabilities, Mr. de Paula said they would see that the company stated exactly what was its point of consolidation. They were, he thought, in fact one of the first companies to do that. It was important to know what the basis was, and they had tried to make that clear. They also made it clear that it covered all subsidiary and sub-subsidiary companies, although the Act of 1929 forgot the latter category. It would be noticed, however, that two companies in Germany were excepted.

An interesting point was raised when subsidiaries were within a closed economy, since the holding company, though it might own a hundred per cent interest, had not absolute control. The basis of consolidation was that capital could be moved from one country to the other, and the problem of how to deal with this position was raised when there was a subsidiary in a country where the currency was blocked.

The company's solution of that problem had been to treat the German companies as they would an associated company, and therefore on the right-hand side of the consolidated statement of assets and liabilities they showed, under investments, the investments in the German companies. It showed that the Dunlop Rubber Company's interest in those German companies stood at £353,000, so that represented the company's maximum capital loss. That was one way of tackling the problem of interests in countries with blocked currencies.

On the left-hand side of the consolidated statement of assets and liabilities there was a technical point, covering a case where a subsidiary held stock in the parent company. Again proposed dividends were shown, and also exchange suspense accounts, being amounts reserved for unrealized exchange differences. In a note at the bottom, they dealt again with the position of the German subsidiary companies. It would be observed that the consolidated statement was audited by the company's auditors.

Statement of Comparative Profits

Another feature of the company's accounts was a statement of comparative profits over a period of five years. A note at the bottom again made it clear how the German companies' profits were dealt with. A further page of the accounts indicated the annual appropriation of the available profits.

The comparative statements showed for the five-year period also the total issued share and loan capital of the company, particulars of the surplus and reserves, and finally the surplus of current assets over current liabilities, firstly of the Dunlop Rubber Company and, secondly, the consolidated position.

The methods they had been discussing, Mr. de Paula said, were an attempt to give a reasonably clear view of the trends of the group and the holding company itself. With an international holding company it was a complex problem. The aim was to give a reasonably clear view in as simple a form as possible of the earnings and financial position first of the group and, secondly, of the holding company itself. He suggested that it could be done quite simply by consolidated statements on some such lines as he had indicated. He did not see how it could be done with the legal Balance Sheet and the Profit and Loss Account.

DUNLOP RUBBER COMPANY, LTD.

Directors:

Chairman: SIR J. GEORGE BEHARRELL, D.S.O.

Joint Managing Directors: C. A. PROCTOR AND JOHN L. COLLYER.

SIR CLIVE L. BAILLIEU, K.B.E., C.M.G.
THE RT. HON. LORD COLWYN, P.C.
SIR ALEXANDER GIBB, G.B.E., C.B.
SIR S. HARDMAN LEVER, BART., K.C.B.
F. ALEXANDER SZARVASY.

Secretary: CHARLES TENNYSON, C.M.G.

DIRECTORS' REPORT

The Directors submit the Balance Sheet of the Company as at 31st December, 1937, together with the Profit and Loss Account for the year 1937. A Statement of Aggregate Profits for 1937 and a Consolidated Statement of Assets and Liabilities as at 31st December, 1937, and a Statement of Comparative results for the years 1933 to 1937 are also submitted.

Trading conditions in the Home market during the greater part of 1937 were favourable, and also in several Overseas markets.

Conditions in the Far East became, and continue to be, most difficult, and violent fluctuations occurred during the year in the price of rubber. The price of standard smoked sheet at 31st December, 1936, was 10¼d. per lb., the price rising rapidly to 1s. 1⅜d. on the 30th March, and falling by the 31st December, 1937, to 7d. per lb., the average for the year being 9½d. per lb. This heavy fall in the price of rubber inevitably entailed a substantial write-down in the valuation of raw material inventories.

The Deutsche Dunlop Gummi Compagnie A-G. declared a dividend out of the profits of that Company for 1936, and the net amount realized by this Company was £10,279, which amount has been taken to credit in these accounts. No credit has been taken in these accounts for the profit earned in 1937 by the German Companies.

Trading Results.

The net profits for the past five years have been as follows—

	£
1933	1,512,866
1934	1,687,687
1935	1,288,244
1936	1,502,707
1937	1,591,017

From the statement on page 101 it will be seen that the total profits available for appropriation amount to £2,180,973.

The Directors' appropriations and recommendations are as follows—

	£	s.	d.
Transfer to Taxation Reserve	495,815	8	4
Transfer to Reserve for Contingencies	250,000	0	0
Preference Dividends paid for the half-year to 30th June, 1937, *less* Income Tax, absorbing	140,625	0	0
The Board proposes paying on the 20th April, 1938, dividends on the "A," "B," and "C" Cum. Preference Shares for the half-year to 31st December, 1937, *less* Income Tax at 5/- in the £, absorbing	140,625	0	0
The Board proposes the payment of a dividend on the Ordinary Stock of 8 per cent, plus a bonus of 1 per cent, both *less* Income Tax at 5/- in the £, payable on the 20th April, 1938, absorbing	562,479	1	6
Balance carried forward to next account	591,428	16	11
	£2,180,973	6	9

The whole of the Preference Dividends guaranteed by this Company in respect of Dunlop Cotton Mills, Ltd., Dunlop Rubber Co. (India), Ltd., and Dunlop Plantations, Ltd., have been provided for out of the 1937 profits of those Companies.

Dunlop Plantations, Ltd., has in addition repaid out of profits of 1937 the sum of £127,930 6s. 5d. in respect of Preference Dividends paid by this Company under its guarantee in previous years. This amount has been credited to the Company's Profit and Loss Account for 1937.

In accordance with established practice, provision has been made in these accounts for this Company's proportion of losses incurred during 1937 by any Subsidiary and Associated Companies that have incurred losses, and the profits of Subsidiary Companies have been included in this Company's profits only to the extent of (*a*) dividends declared in respect of the year 1937, (*b*) the dividend declared by the Deutsche Dunlop Gummi Compagnie A-G. in respect of the year 1936, and (*c*) an appropriate amount in respect of the profits earned in 1937 by certain Subsidiary Companies, which had previously sustained losses for which this Company had made provision in full.

Throughout the organization, as in preceding years, inventories have been conservatively valued; all raw material inventories having been valued at the lower of cost or market prices at the 31st December last. Ample provision has been made for bad and doubtful debts, and every known loss at home and abroad has been provided for in the accounts.

BALANCE SHEET (pages 96 to 99).

The following statement shows in comparative form for 1936 and 1937 the Assets of the Company—

	1936	1937	Increase *Decrease*
	£	£	£
Fixed Assets	3,764,616	3,654,522	*110,094*
Investments and Advances	14,543,007	15,338,313	795,306
Current Assets	6,410,037	6,217,575	*192,462*
	£24,717,660	25,210,410	492,750

Fixed Assets.—Adequate provision has been made for depreciation, and all Fixed Assets have been thoroughly maintained.

Investments and Advances.—The increase of £795,306 represents mainly the provision of additional capital for various subsidiaries in order to finance an increased volume of business.

The Capital and Liabilities are as follows—

	1936	1937	Increase *Decrease*
	£	£	£
Share Capital	12,733,023	12,733,023	—
Surplus and Reserves	5,146,355	5,409,329	262,974
	£17,879,378	18,142,352	262,974
Debenture Stock	3,433,135	3,390,375	*42,760*
Amounts owing to Subsidiary and Associated Companies	1,438,860	1,533,240	94,380
Current Liabilities and Provisions	1,966,287	2,144,443	178,156
	£24,717,660	25,210,410	492,750

Surplus and Reserves.—As already stated, the Directors have transferred from Profit and Loss Account the sum of £250,000 to the credit of the Reserve for Contingencies.

CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES (pages 102 to 105).

Owing to the continuance of the Exchange restrictions in Germany and for the reasons explained in previous reports, the various items from the Balance Sheets of the German Companies have not been included in the Consolidated Statement. The investments in and advances to these Companies are, therefore, shown separately under Item II (*d*) on page 103. Under a special arrangement advances amounting to £105,195 were made in 1934–5 and these were repaid in 1937, which accounts for the decrease in this item.

COMPARATIVE RESULTS, 1933–1937 (pages 106 to 109).

Comparative results for the past five years are given with a view to enabling shareholders to obtain a clear view of the main trends of the Company's financial position.

The Director due to retire by rotation is Sir S. Hardman Lever, Bart., K.C.B., and he offers himself for re-election.

The Auditors, Messrs. Stokes Brothers & Pim, and Messrs. Whinney, Smith & Whinney, retire, and being eligible, offer themselves for re-appointment.

By Order of the Board,

J. GEORGE BEHARRELL, *Chairman.*
C. A. PROCTOR,
JOHN L. COLLYER, } *Joint Managing Directors.*
C. TENNYSON, *Secretary.*

25th March, 1938.

STATEMENT OF PROFITS for the year 1937

1936 £		£	£
2,200,392	I. THE AGGREGATE PROFITS OF THE DUNLOP RUBBER CO., LTD., for the year 1937, including its proportion of the profits, *less* losses of all Subsidiary and Sub-subsidiary Companies after providing for Depreciation, etc., but before providing for guaranteed Preference Dividends of Subsidiary Companies amount to . . .		2,478,000
18,764	II. IN ADDITION, the Dunlop Rubber Company's proportion of various items which do not represent normal earnings attributable to the current year, amounts to		25,926
2,219,156	III. AGGREGATE TOTAL		2,503,926
	IV. FROM THE RESULTS OF SUBSIDIARY AND SUB-SUBSIDIARY COMPANIES INCLUDED ABOVE THERE HAS BEEN DEDUCTED—		
243,496	(*a*) The Dunlop Rubber Company's proportion of British and Foreign Taxation paid by or provided in the accounts of such companies . .	355,407	
114,375	(*b*) The whole of the Guaranteed Preference Dividend of Dunlop Plantations, Ltd., for the year to 30th November, 1937, paid by that Company . .	112,500	
111,515	(*c*) The whole of the Guaranteed Preference Dividend of Dunlop Cotton Mills, Ltd., for the year to 31st January, 1938, paid by that Company . .	109,687	
13,595	(*d*) The whole of the Guaranteed Preference Dividend of Dunlop Rubber Co. (India), Ltd., for the year to 31st December, 1937, paid by that Company	13,575	
72,620	(*e*) The Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve	162,497	
555,601			753,666
1,663,555	V. BALANCE AVAILABLE TO THE DUNLOP RUBBER CO., LTD., as per that Company's Profit and Loss Account (pages 100 and 101) . . .		1,750,260
160,848	VI. DEDUCT: Interest on Debenture Stock and Loans		159,243
1,502,707	VII. LEAVING THE NET PROFIT AS PER THE DUNLOP RUBBER COMPANY'S PROFIT AND LOSS ACCOUNT (pages 100 and 101)		1,591,017
589,940	VIII. *Add* Balance brought forward from last year		589,956
£2,092,647	IX. TOTAL AVAILABLE		£2,180,973

DUNLOP RUBBER
BALANCE SHEET AS AT

1936 £		Authorized Shares & Stock £	Issued Shares & Stock £	£
	I. SHARE CAPITAL—			
	1,000,000 6½ per cent "A" Cum. Pref. Shares of £1 each	1,000,000	1,000,000	
	1,000,000 7 per cent "B" Cum. Pref. Shares of £1 each	1,000,000	1,000,000	
	3,000,000 10 per cent "C" Cum. Pref. Shares of 16/- each	2,400,000	2,400,000	
	£15,600,000 Ordinary Stock	15,600,000	8,333,023	
12,733,023				12,733,023
		£20,000,000		
	II. SURPLUS AND RESERVES—			
1,150,832	(a) General Reserve (including balance of Share Premium Account)		1,150,832	
2,315,000	(b) Special Reserve—against investments in and advances to Subsidiary Companies		2,315,000	
	(c) Reserve for Contingencies	782,006		
	Add Transfer from Profit and Loss Account (page 100)	250,000		
790,106			1,032,006	
250,000	(d) Dividend Equalization Reserve		250,000	
50,461	(e) Reserve for Inter-Company Profits in Inventory Valuations of Subsidiary Companies		70,062	
589,956	(f) Surplus, i.e. Profit and Loss Account Balance after providing for proposed dividends and bonus as per Profit and Loss Account (pages 100 and 101)		591,429	
5,146,355				5,409,329
17,879,378				18,142,352
	III. DEBENTURE STOCK secured upon assets of the Company—			
	4% Debenture Stock		3,500,000	
	Less Redeemed and cancelled to date		109,625	
3,433,135				3,390,375
	IV. AMOUNTS OWING TO SUBSIDIARY AND ASSOCIATED COMPANIES— (Less Dividends since declared)			
	(a) Subsidiary Companies		1,494,268	
	Less Company's own Debenture Stock included therein		11,028	
1,388,686			1,483,240	
50,174	(b) Associated Companies		50,000	
1,438,860				1,533,240
751,373	*Carried forward*			£23,065,967

COMPANY, LIMITED
31st DECEMBER, 1937

1936 £		£	£
	I. FIXED ASSETS at Cost, *less* Realizations and Depreciation—		
1,814,954	(a) Freehold Land and Buildings . .	1,729,040	
333,526	(b) Leasehold Premises	330,561	
847,051	(c) Plant, Machinery, Tools, and Moulds.	839,069	
116,814	(d) Furniture, Fittings, and Fixtures .	105,220	
13,198	(e) Cars and Delivery Vans . . .	11,808	
639,073	(f) Patents, Trade Marks, Licences, and Royalty Agreements as valued by the Directors at 31st December, 1926, *plus* additions at cost, *less* sales and amounts written off .	638,824	
3,764,616			3,654,522
	II. INVESTMENTS AND ADVANCES at Cost, *less* amounts written off and Reserves—		
	Subsidiary Companies:		
6,365,943	(a) Shares	7,040,034	
7,046,198	(b) Advances and Current Accounts (including dividends since declared) .	7,092,615	
13,412,141	(In respect of this amount there is a Special Reserve of £2,315,000 as *per contra*)	14,132,649	
	Associated Companies:		
1,003,599	(c) Shares	1,002,349	
94,983	(d) Advances and Current Accounts .	114,410	
	Sundry Investments:		
30,500	(e) Cash in Hands of Trustees for Debenture Holders	86,724	
1,784	(f) Trade Investments	2,181	
14,543,007			15,338,313
	III. CURRENT ASSETS—		
2,859,632	(a) Inventories of finished and unfinished goods, raw materials and stores, etc., at or below cost as certified by the Company's Officials . .	3,237,682	
992,274	(b) Sundry Debtors, *less* Reserves . .	1,168,264	
37,296	(c) Leasehold Redemption Policy at Surrender Value	41,971	
106,806	(d) Bills Receivable	108,245	
7,500	(e) Other Securities at Cost . . .	7,500	
2,374,220	(f) Bank Balances, Deposits, Cash in Hand and in Transit	1,616,746	
32,309	(g) Deferred Charges	37,167	
6,410,037			6,217,575
£24,717,660		*Carried forward*	£25,210,410

1936			
£		£	£
22,751,373	*Brought forward*		23,065,967
	V. CURRENT LIABILITIES AND PROVISIONS—		
685,215	(*a*) Sundry Creditors, including accrued Debenture Interest . . .	726,339	
566,250	(*b*) Taxation Reserve	715,000	
	(*c*) Proposed Dividends—		
142,969	Preference Dividends for half-year to 31st December, 1937, *less* Income Tax	140,625	
571,853	Ordinary Dividend and Bonus for the year to 31st December, 1937, *less* Income Tax . . .	562,479	
1,966,287			2,144,443
£24,717,660			£25,210,410

Report of the Auditors to the Members of the Dunlop Rubber Company, Limited.

In accordance with the provisions of Section 134, sub-section 1, of the Companies Act, 1929, we report as follows—

We have audited the above Balance Sheet with the books of the Company in which have been incorporated the Returns from Branches certified by Local Auditors or the Branch Officials, and we have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company and the said Returns.

21st March 1938.

1936 £		£	£
24,717,660	Brought forward		25,210,410
£24,717,660	NOTE.—The Company has guaranteed the Preference Shares of Dunlop Cotton Mills Ltd., Dunlop Plantations, Ltd., and the First Preference Shares of Dunlop Rubber Co. (India), Ltd., as regards Capital, Premium and Dividends, and is also contingently liable in respect of the guarantee of Bank advances to certain Subsidiary and Associated Companies.		25,210,410

STOKES BROS. & PIM,
WHINNEY, SMITH & WHINNEY, } *Auditors.*
Chartered Accountants.

J. GEORGE BEHARRELL, *Chairman.*
C. A. PROCTOR,
JOHN L. COLLYER, } *Joint Managing Directors*
F. R. M. DE PAULA, *Controller of Finance.*

DUNLOP RUBBER
PROFIT AND LOSS ACCOUNT

Dr.

1936 £			£	£
351,248	I.	To Depreciation		337,610
8,000	II.	„ Directors' Fees		8,000
1,663,555	III.	„ Balance carried down		1,750,260
2,022,803				2,095,870
160,848	IV.	„ Interest on Debenture Stock and Loans		159,243
1,502,707	V.	„ Net Profit carried down		1,591,017
1,663,555				1,750,260
394,900	VI.	„ Transfer to Taxation Reserve		495,815
100,000	VII.	„ Transfer to General Reserve		—
150,000	VIII.	„ Transfer to Reserve for Contingencies		250,000
	IX.	„ PREFERENCE DIVIDENDS:		
142,969		(a) Half-year to 30th June, 1937 (already paid), *less* Income Tax	140,625	
142,969		(b) Proposed for the half-year to 31st December, 1937, *less* Income Tax	140,625	281,250
	X.	„ ORDINARY DIVIDEND AND BONUS:		
571,853		Proposed for the year to 31st December, 1937, *less* Income Tax		562,479
589,956	XI.	„ Balance carried forward as per Balance Sheet		591,429
£2,092,647				£2,180,973

COMPANY, LIMITED

for the year ended 31st December, 1937 Cr.

1936		
£		£
2,011,768	I. By Profit on Trading, Interest, Dividends on Investments, including those received from or since declared by Subsidiary and Associated Companies, and Miscellaneous Receipts . . .	1,957,661
	II. „ Repayment on account of Guaranteed Preference Dividends paid by the Dunlop Rubber Co., Ltd., in previous years:	
11,035	Dunlop Plantations Ltd.	127,930
—	III. „ Net Dividend received from the Deutsche Dunlop Gummi Cie. A-G. in respect of the year 1936 .	10,279
2,022,803		2,095,870
1,663,555	IV. „ Balance brought down	1,750,260
1,663,555		1,750,260
1,502,707	V. „ Net Profit brought down	1,591,017
589,940	VI. „ Balance brought forward from 1936 . . .	589,956

NOTE.—The Profits of Subsidiary Companies are included in the [illegible] to the extent of (a) [illegible] espect of the year [illegible] ed by the Deutsche [illegible] A-G. in respect of [illegible] ppropriate amount in respect of the profits earned in 1937 by certain Subsidiary Companies which had previously sustained losses for which this Company had made provision in full.
Certain Subsidiary Companies sustained losses in 1937 and full provision for this Company's proportion thereof has been made out of the profits above set forth.
In the accounts of the Subsidiary Companies these losses have been carried forward to the extent to which they are not provided for out of undistributed profits of those Companies.

J. GEORGE BEHARRELL,
C. A. PROCTOR,
JOHN L. COLLYER,
Directors.

£2,092,647	£2,180,973

CONSOLIDATED STATEMENT OF ASSETS

DUNLOP RUBBER COMPANY LIMITED

Incorporating the figures of the audited Balance Sheets (after elimination of inter-company Companies (with two exceptions stated under the heading of Investments item II (d) below) of the Ordinary Shares or Stock of those companies and over 50% of the voting control.

1936 £			£	£
	I. ISSUED SHARE CAPITAL OF THE DUNLOP RUBBER COMPANY, LIMITED—			
	1,000,000 6½% "A" Cum. Pref. Shares of £1 each fully paid		1,000,000	
	1,000,000 7% "B" Cum. Pref. Shares of £1 each fully paid		1,000,000	
	3,000,000 10% "C" Cum. Pref. Shares of 16/- each fully paid		2,400,000	
	£8,333,023 Ordinary Stock . . .		8,333,023	
12,733,023				12,733,023
	II. SURPLUS AND RESERVES—			
1,336,199	(a) General Reserves		1,376,175	
2,315,000	(b) Special Reserve in the accounts of the Dunlop Rubber Company, Limited, in respect of Subsidiary Companies.		2,315,000	
790,106	(c) Reserves for Contingencies. . . .		1,123,005	
250,000	(d) Dividend Equalization Reserve . .		250,000	
689,066	(e) Surplus, i.e. Profit and Loss Account Credit Balances, after providing for Proposed Dividends and Bonus .		697,377	
5,380,371				5,761,557
18,113,394				18,494,580
	III. INTEREST OF OUTSIDE SHAREHOLDERS—			
6,020,550	Preference and Ordinary Share Capital of Subsidiaries held by Outside Shareholders, after taking into account their proportion of General Reserves and Undistributed Profits or Losses attributable thereto			5,993,883
	IV. DEBENTURE STOCK, MORTGAGES, AND LOANS—			
	(a) Dunlop Rubber Company Limited, Debenture Stock	£ 3,390,375		
	Less: Held by Subsidiary Company .	11,028		
3,422,107			3,379,347	
558,233	(b) Loans		390,075	
10,138	(c) Mortgage		10,000	
3,990,478				3,779,422
£28,124,422	*Carried forward*			£28,267,885

AND LIABILITIES as at 31st December, 1937
AND SUBSIDIARY COMPANIES

balances) of the Dunlop Rubber Company Limited and all Subsidiary and sub-Subsidiary in which the Dunlop Rubber Company Limited and any of its Subsidiaries hold over 50%

1936 £		£	£
	I. FIXED ASSETS, at cost *less* realizations and provisions for depreciation and obsolescence—		
10,283,592	(*a*) Land, Factory and other Buildings, Cotton Mills, Plant, Tools, Furniture, Cars, etc.	10,161,435	
4,149,116	(*b*) Dunlop Plantations, Ltd., Estates, Buildings, Plant, etc.	4,093,505	
639,074	(*c*) Patents, Trade Marks, Licences, etc.	638,824	
15,071,782			14,893,764
	II. INVESTMENTS at Cost, *less* amounts written off—		
1,057,758	(*a*) Investments in Associated Companies.	1,051,371	
30,500	(*b*) Cash in hands of Trustees for Debenture Holders	86,724	
13,489	(*c*) Trade and Sundry Investments.	15,104	
458,964	(*d*) Investments in German Companies: Shares and Advances	353,769	
1,560,711			1,506,968
	III. CURRENT ASSETS—		
7,332,013	(*a*) Inventories at or below cost	8,859,843	
3,676,581	(*b*) Sundry Debtors, Bills Receivable, etc., *less* Reserves	3,977,785	
107,171	(*c*) Amounts owing by Associated Companies	136,214	
62,326	(*d*) Other Securities	66,007	
2,449,104	(*e*) Bank Balances and Cash, *less* Bank Loans	1,355,196	
124,466	(*f*) Deferred Charges	141,727	
13,751,661			14,536,772
1,386,373	IV. GOODWILL ACCOUNTS, including the difference between the values at which inter-company holdings of shares are taken as assets into the Balance Sheets and their Par values, *less* undistributed profits at the date of the acquisition of such shares		1,485,755
£31,770,527	Carried forward		32,423,259

1936 £		£	£
28,124,422	*Brought forward*		28,267,885
	V. CURRENT LIABILITIES AND PROVISIONS—		
1,852,766	(a) Sundry Creditors and Accrued Charges .	2,120,822	
54,396	(b) Amounts owing to Associated Companies	53,489	
869,860	(c) Taxation Reserves	1,144,385	
	(d) Proposed Dividends—		
714,822	Dunlop Rubber Company Limited, Dividends and Bonus . . .	703,104	
161,175	Dividends of Subsidiaries to Outside Shareholders	153,762	
3,653,019			4,175,562
10,558	VI. EXCHANGE SUSPENSE ACCOUNTS, BEING AMOUNTS RESERVED FOR UNREALIZED EXCHANGE DIFFERENCES		12,115
£31,787,999			£32,455,562

We have examined the above Consolidated Statement of Assets and Liabilities with the Balance Sheet of the Dunlop Rubber Company Ltd., at 31st December, 1937, as audited by us, and with the Balance Sheets of the Subsidiary and Sub-subsidiary Companies as audited by their respective Auditors. In the case of certain Subsidiary Companies the Balance Sheets are at dates other than 31st December, 1937, and the adjustments consequent thereon have been made. In our opinion the statement set forth above has been correctly compiled from the said Balance Sheets (other than those of the Companies in Germany), after giving effect to the necessary adjustments in respect of Foreign Exchange, so as to exhibit a true and correct view of the consolidated position of the Companies at 31st December, 1937.

21st March, 1938.

STOKES BROS. & PIM,
WHINNEY, SMITH & WHINNEY, } *Chartered Accountants.*

1936 £		£	£
31,770,527	*Brought forward*		32,423,269
17,472	V. **SUSPENSE ACCOUNT** for transactions with Subsidiary Companies between the dates of their Balance Sheets and 31st December, 1937		32,293

NOTE.—For the reasons given in the Directors' Report (page 94) the investments in and advances to the German Companies as at the 31st December, 1937, are shown separately under Item II (*d*) above and consequently the Assets and Liabilities of those companies have not been classified under their respective headings.

£31,787,999

J. GEORGE BEHARRELL, *Chairman.*
C. A. PROCTOR, } *Joint Managing Directors.*
JOHN L. COLLYER, }
F. R. M. DE PAULA, *Controller of Finance.*

COMPARATIVE

STATEMENT OF PROFITS

I. The Aggregate Profits of the Dunlop Rubber Co., Ltd., including its proportion of the profits less losses of all Subsidiary and Sub-subsidiary Companies after providing for Depreciation, etc., but before providing for guaranteed Preference Dividends of Subsidiary Companies . . . . . .

II. The Dunlop Rubber Company's proportion of various items which do not represent normal earnings attributable to the current year . . . .

III. Aggregate Total . . . .

IV. From the results of Subsidiary and Sub-subsidiary Companies included above there has been deducted—

(a) The Dunlop Rubber Company's proportion of British and Foreign Taxation paid by or provided in the accounts of such companies .

(b) Guaranteed Preference Dividends . . . .

(c) The Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve . . .

V. Balance available to the Dunlop Rubber Co., Ltd. . . . . . .

VI. Deduct—

(a) Guaranteed Preference Dividends of Subsidiary Companies borne by the Dunlop Rubber Co., Ltd. . . . .

(b) Interest on Debenture Stock, etc. . . . .

VII. Leaving the Net Profit as per the Dunlop Rubber Company's Profit and Loss Accounts . . . .

VIII. Add: Balance brought forward . . . .

IX. Total available . . . .

RESULTS. 1933—1937

1933	1934	1935	1936	1937
£	£	£	£	£
2,255,973	2,276,336	1,860,073	2,200,392	2,478,000
90,671	9,183	9,128	18,764	25,926
2,346,644	2,285,519	1,869,201	2,219,156	2,503,926
229,440	167,895	104,752	243,496	355,407
164,859	243,153	243,199	239,485	235,762
83,421	47,932	61,887	72,620	162,497
477,720	458,980	409,838	555,601	753,666
1,868,924	1,826,539	1,459,363	1,663,555	1,750,260
70,882	—	—	—	—
285,176	138,852	171,119	160,848	159,243
1,512,866	1,687,687	1,288,244	1,502,707	1,591,017
442,208	578,415	588,652	589,940	580,956
£1,955,074	£2,266,102	£1,876,896	£2,092,647	£2,180,973

NOTE.—The 1934, 1935, and 1937 profits made in Germany are not included in the above statement. Included in the 1937 profits is a dividend received in respect of the year 1935.

COMPARATIVE

ANNUAL APPROPRIATIONS OF AVAILABLE PROFITS, 1933-1937:

I. Transfer to Taxation Reserve . . . .

II. Transfer to General Reserve . . . .

III. Transfer to Reserve for Contingencies . . . .

IV. Transfer to Dividend Equalization Reserve . . . . .

V. Dividends on the "A," "B," and "C" Cum. Preference Shares (*less* Income Tax)

VI. Dividend on the Ordinary Stock (*less* Income Tax) . . . . .

VII. Balance carried forward . . . .

DUNLOP RUBBER CO., LTD.—

Issued Share and Loan Capital . . . .

Surplus and Reserves—

I. General Reserve . . . .

II. Special Reserve—against investments in and advances to Subsidiary Companies .

III. Reserves for Contingencies . . . .

IV. Dividend Equalization Reserve . . . .

V. Reserve for Inter-Company Profits in Inventory Valuations of Subsidiary Companies . . . .

VI. Surplus, i.e. Profit and Loss Account Balance after providing for proposed dividends . . . .

SURPLUS OF CURRENT ASSETS OVER CURRENT LIABILITIES.

I. Dunlop Rubber Co., Ltd. (pages 97 and 98) . . . .

II. Consolidated Position (pages 103 and 104) . . . .

RESULTS. 1933—1937 (contd.)

1933	1934	1935	1936	1937
£	£	£	£	£
403,956	550,060	419,761	394,900	495,815
200,000	—	—	100,000	—
—	100,000	100,000	150,000	250,000
—	250,000	—	—	—
285,938	290,625	288,281	285,938	281,250
486,765 (8%)	486,765 (8%)	478,914 (8%)	571,853 (8% + Bonus 1%)	562,479 (8% + Bonus 1%)
578,415	588,652	589,940	589,956	591,429
£1,955,074	£2,266,102	£1,876,896	£2,092,647	£2,180,973
14,592,016	15,040,412	15,725,305	16,166,158	16,123,398
1,124,843	1,124,843	1,124,843	1,150,832	1,150,832
2,000,000	2,000,000	2,000,000	2,315,000	2,315,000
643,260	645,443	692,027	790,106	1,032,006
—	250,000	250,000	250,000	250,000
369	46,998	32,922	50,461	70,062
578,415	588,652	589,940	589,956	591,429
£4,346,887	£4,655,936	£4,689,732	£5,146,355	£5,409,329
3,193,556	3,623,415	4,274,111	4,443,750	4,073,132
8,067,034	8,453,194	9,505,539	10,098,642	10,361,210

Arguments Against the System

One of the old arguments against the system was the fear that it gave information to competitors, but it was an argument that he personally had never been able to understand fully. His company was not telling competitors details of technical formulae, who the customers were, or what their trading terms were, and he could not see what information to the detriment of the company could be obtained from the published accounts. On the contrary, it was the issue of accounts concealing information which was likely to give rise to rumours that might react against a company.

Another argument put forward against these comprehensive accounts was that they were all very well when times are good, but it was a different matter when times were bad. Why was that so? asked Mr. de Paula. No board of directors could harness the industrial tide, and every one had the past accounts, so there was no difficulty in drawing comparisons. So far as he could see, the only time directors were likely to get into trouble was when they issued accounts which did not show the true position, and tried to make it look better than it really was. His own feeling was that both from an ethical and a commercial point of view the publication of full and informative accounts was in the long run the only wise policy.

Discussion

This concluded Mr. de Paula's address, and he was asked by a member: "In the event of a company acquiring a subsidiary and paying a price well below par for shares—the company having a deficit on the Profit and Loss Account—what provision should the holding company make for the loss in the next account after acquisition?"

Mr. de Paula replied that the purchase of the shares of a company with a deficit would obviously be made at a price which took the deficit into account, and therefore in the subsequent Profit and Loss Account no provision would be made at all. Upon consolidation, the deficit on profit and loss account would be set off against the discount on the purchase price of the shares. These two adjustments would be reflected in the goodwill item on the consolidated statement of assets and liabilities.

Another member asked Mr. de Paula whether on the Balance Sheet of the holding company the special reserve against investments in and advances to subsidiary companies—shown in the Dunlop account on the left-hand side—would not be better shown on the other side of the Balance Sheet as a deduction from the investments and advances item.

Mr. de Paula replied that the point was a good one. It was quite open to question whether the alternative might be better.

Mr. W. H. Newton, F.C.A., proposing a vote of thanks to Mr. de Paula, said it had been a very illuminating address, and it was extremely difficult to criticize anything that had been said. In dealing

with a paramount company like Dunlop, the arguments were admirable, but there was a difference between that sort of company and small group companies, to which disclosure of so much information might be disastrous. He confessed frankly, however, that in considering the form of accounts of holding companies, he had studied those of the Dunlop Company and found them of great assistance.

Chapter VII

The Treatment of Dividends and Income Tax in Published Accounts

The following letters to "The Accountant" and to "Accountancy" are reproduced as they raise points of interest upon which opinions differ. In the public interests uniformity of practice would seem to be desirable.

I HAVE read with great interest Mr. Smallpiece's article on the above subject in your issue of 19th July.

The method that Mr. Smallpiece recommends regarding Income Tax on dividends is orthodox and in line with what those in my generation were all taught in our student days.

The alternative method, which I have strongly advocated for many years, is unorthodox, and it is a matter of opinion as to whether or not this method shows the position more clearly to shareholders. Personally, I think it does, and I do not agree with Mr. Smallpiece when he says that this method of presentation "does not give a true picture of the distribution."

In my book, *The Principles of Auditing*, I have endeavoured to make my views on this matter clear. May I, therefore, quote from the Tenth Edition, pages 266 to 270—

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"As regards the deduction of Income Tax from dividends, the Income Tax liability of a company is computed upon the basis of the company's earnings and is in no way affected by its dividend distributions. The Income Tax deducted from dividends does not have to be accounted for to the Inland Revenue as is the case with loan interest and other such annual payments.

A distribution of profits by a company is taxed income in the hands of members and therefore, of course, has to be included in the individual member's Income Tax return at the gross amount. Therefore, to declare a dividend less Income Tax is convenient, as it makes clear to members the exact amount to be included in their Income Tax returns. But from the company's point of view it is only the net amount of the dividend, i.e. the cash distribution, that affects its financial position. For example, a dividend of 8 per cent less Income Tax at 5s. is exactly the same as one of 6 per cent tax free both as regards the company and each member. . . ."

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"Before arriving at a company's net profit available for distribution there has to be taken into account not only the reserves which the directors in the exercise of their discretion deem it expedient to set aside, but also the provision for Income Tax, which cannot be less than, but may exceed, the amount of the company's statutory liability. That which remains for distribution therefore is in truth and in fact a taxed, or what might be termed a 'Net' fund. It seems to the writer but elementary logic that that which is paid out of that fund by way of dividend from which tax is deducted should likewise be expressed as a net sum."

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"Furthermore, it is submitted that from the practical point of view the inclusion of the proposal dividends less Income Tax makes accounts much simpler in form and easier to read. That this form of presentation is appreciated by the public is evidenced by the widespread and enthusiastic reception it has received in the Press and by the general public, and, furthermore, by the fact that an ever-increasing number of companies are adopting this method of presentation."

The exact effect of the combined appropriations is, I submit, equally clear under both methods of presentation, by a simple means of comparing the "carry forward" at the beginning and end of the year. If a shareholder is incapable of doing this, I am afraid he will never understand any accounts, however carefully prepared.

To "The Accountant," 22nd *July*, 1941

* * *

I have read with great interest the letter upon this subject from Mr. Smallpiece and others and which appeared in your issue of the 4th inst.

I also agree with the contention of *The Economist* that it is most desirable that a standard practice should be evolved.

Regarding the standard suggested by Mr. Smallpiece and his colleagues, except for one point, I am in agreement and in fact have followed this practice for some years.

Messrs. Smallpiece & Co. recommended that dividends should be shown gross in the appropriation statement and that it is immaterial whether the "tax recovered or recoverable" from the dividends is shown as a deduction from the gross provision for tax or from the dividends themselves. The criticism of *The Economist* is directed against the variety of present practice. If therefore a standard is to be evolved I suggest that we should make up our minds upon this point; which, in my opinion, is of importance.

Personally I have always advocated that the Income Tax should be deducted from dividends and hence that dividends should be shown "net" in the appropriation statement.

My unorthodox view is that having earned a profit the State as a sleeping partner takes a share and *what remains* represents the balance available for dividends and appropriations.

For example—

	£	%
Net Profit	200,000	
Taxation	120,000	60
Reserve	30,000	15
Dividend (Net)	50,000	25
	£200,000	100

The taxation is a cash payment to the Revenue and falls in this case in whole upon the equity holders and £50,000 is the cash payment to the shareholders, whether the dividend is declared less tax or free of tax.

The object of deducting Income Tax from ordinary dividends is to make clear to each shareholder that the distribution he has received is out of a taxed fund and the dividend counterfoil therefore shows the gross amount that should be included in the shareholder's Income Tax return.

From the company's point of view the net dividend represents, in my opinion, the true distribution, and to show the gross dividend in the appropriation statement and to reduce the provision for taxation by the amount of the Income Tax on the dividend, does not give a clear and realistic view of affairs but introduces, I submit, a confusing and unnecessary complication.

To "The Accountant," 7th *July*, 1942

* * *

Reserves for Income Tax

I have read with interest the article upon the above subject in your April issue. As the argument developed in the article appears to me to be founded on a misunderstanding of the recommendations of the Institute of Chartered Accountants, will you allow me respectfully to submit my observations?

In the first place, it will be agreed that recommendations III (2) (*b*) and (5) make it clear that provision for the estimated future liability to Income Tax is, in the Council's opinion, a voluntary provision at the discretion of the directors. It is, in fact, merely a question of financial policy. The reasons for the recommendation of the adoption of the policy, it seems to me, are exactly in line with the basic reasons which led to the adoption of the "Pay as You Earn" legislation under Schedule "E."

The problem arises solely from the fact that Schedule "D" assessments are based upon the previous year's trading results, and therefore if, for example, in 1942 a company earned a profit of £100,000, followed in 1943 by one of £5,000, the Income Tax burden upon the year 1943 would be overwhelming if only the legal liability had been provided for in 1942, and the company might experience great difficulty in financing this heavy Income Tax payment.

These circumstances are an unescapable fact arising directly out of the method of assessment, and the only certain means of making sure that no such financial difficulties shall arise is to follow the Institute's recommendation and hold back out of available profits the estimated future liability to Income Tax.

As I understand it, the Institute's recommendation is put forward as representing the soundest financial policy, and it is not suggested for one moment that it should be considered compulsory.

So far as the Profit and Loss Account is concerned, when the change is first made one year will have to bear income tax for two years, but thereafter each year will bear only the estimated Income Tax upon the results of that year.

Regarding the Balance Sheet, in accordance with recommendation (5), "any provision for (or in excess of) the estimated future liability to Income Tax in respect of the fiscal year commencing after the date of the balance sheet should not be included with current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described."

I cannot therefore understand how it can be said that the adoption of the Institute's recommendation could create "what may well be a misleading item in the Balance Sheet." Many companies will, no doubt, find it impossible to face the double burden of Income Tax involved in the change-over, but in the cases where this can be done could it be denied that that is the soundest financial policy? If so, should it not be regarded as the best practice?

It may be that I have misunderstood the argument put forward in your article, and that what it means is that the counsel of perfection is not always attainable in practice. If that is the argument, then all will agree.

When, after the last war, industrial profits fell suddenly and extensively, all of us who were then in practice will remember many cases where acute financial difficulties arose owing to shortage of funds wherewith to liquidate the heavy Income Tax demands. It was that experience that convinced me that the only sound policy was to hold back profits to cover the estimated future liability to Income Tax, and it is for this reason that I find myself in entire agreement with the Institute's recommendation upon this point.

To "Accountancy," 17th *April*, 1944

Chapter VIII

Accountants and Accounts

Letters to "The Accountant," 1942

THE article under this heading in *The Economist* of the 26th September, as reproduced by you on 17th October, deals trenchantly with a matter which increasingly attracts public attention, if only for the reason that the best hope of remedying weaknesses in the present situation is to be achieved by bringing every angle of criticism and information to bear on the whole subject. There are few who would deny that an improvement in the current standard of accounting, and particularly in the current standard of disclosure in published accounts, is desirable: quite certainly, this view would not be contested by the overwhelming majority of those best able to judge, namely professional accountants, who are in daily practical contact with the details of the problem. But it may be suggested that it would be very regrettable if the large class of readers whose opinions are influenced by their reading of *The Economist* and of other financial organs (which, incidentally, quote *The Economist* article with tacit approval), should receive the impression that the article expresses the only possible point of view: for there is indeed another which it is the purpose of the present contribution to emphasize.

In the first place, every unbiased observer must admit that recent years have witnessed a limited, but very definite, improvement in the general standard maintained. An interesting treatise could be written by way of detailed comparison in important selected instances between the form and content of published accounts in 1942 and that which was deemed satisfactory say a dozen years ago. It is pertinent to inquire by what influence this manifest improvement has been effected. Certainly the Companies Act, 1929, has had something to do with the matter, but it may be confidently suggested that the requirements of that statute have not been the main force at work; it may be claimed that the real upward drive has been applied from other quarters. Readers of the technical journals of the accountancy profession, such as *The Accountant* and *Accountancy*, expressing the views respectively of Chartered and Incorporated Accountants, must be conscious of the general desire of the profession that recognized standards should be set and that investors and the public should be furnished with suitable information whereby, within the compass of complicated facts, the position and progress of industrial undertakings would be more readily understood.

The profession, however, has no compelling powers, whatever its own convictions may be, to enforce and carry them into effect, but it

has opportunities of suggestion and persuasion which, the public may be assured, are exercised to the full. Generally speaking, progressive directorates have not been slow to take advantage of the advice thus tendered. Nevertheless, the hard and inescapable fact is that, subject to the narrow limits of the statutory minima, the powers of an auditor in the matter of the presentation of accounts are persuasive only, and in the face of boards which may be timid of innovation or overborne by the weight of tradition, he is almost powerless. Under present conditions it is clearly incorrect to charge the profession with responsibility for admitted imperfections which are not of its own seeking.

The writer of the article states that the profession has no very intimate contact with accountants employed in industry but the profession is not so backward as the article would lead its readers to suppose. For example, members of the Institute of Chartered Accountants have for long been conscious of the desirability of a closer co-operation between those members who are in public practice and others who hold responsible industrial and commercial positions. In response to this feeling there has recently been formed by the Council of the Institute a Taxation and Financial Relations Committee whose terms of reference lay upon it, subject to the authority of the Council, the duty to "maintain an effective liaison between practising and non-practising members of the Institute in regard to the financial problems of the business community." This Committee, whose proceedings are reported in *The Accountant* from time to time, finds plenty of scope for its activities. It is very relevant to mention that of the forty-four members of the Committee and its sub-committees, no fewer than thirteen, including its vice-chairman, occupy positions of responsibility with well-known industrial and commercial undertakings. The Provincial Societies are setting up similar committees which will likewise be strongly composed.

The article rightly draws attention to the progress towards a high and uniform standard which has been made in the United States, but it does not mention the real reason why American development has been more rapid than British. Is not the explanation to be found in the interest which is taken by the New York Stock Exchange in demanding an adequate standard of accounting disclosure? The London Stock Exchange has done something, notably in requiring consolidated accounts from all holding companies applying for new quotations, and, if it would use the extra-legal power which it possesses, some of the objects which *The Economist* and the accountancy profession have in common view might more quickly be secured.

The conclusion of the matter seems to be that improvement is desired both by *The Economist* and by all thinking men, including those in the accountancy profession: but the machinery for securing a unifrom observance of a recognized standard does not yet exist Either we must await a new Companies Act, or, in the meantime

look to bodies such as the Stock Exchange to exercise pressure. It is the result which matters and it is the result, brought about by whatever means, which is desired by the accountancy profession.

31st *October*, 1942

* * *

With reference to Mr. Senior's letter in your issue of 21st November.

May I, in the first place, express my great appreciation for his courteous and generous references to myself.

In my previous letter on this subject I did not intend to convey the suggestion "that progress towards a uniform standard should be left in the hands of the London Stock Exchange."

The point I was trying to make was that some form of compulsion would be essential in order to attain the adoption of a uniform standard by the boards of all companies.

The Taxation and Financial Relations Committee has this whole matter under active consideration, and Mr. Senior will, I am sure, agree with me that it would be unfair to prejudge the results of that committee's work.

12th *December*, 1942

Chapter IX

Design of Accounts

Article in "Accountancy," July, 1944.

THE accountancy profession will be greatly indebted to Mr. F. Sewell Bray and Mr. H. Basil Sheasby for their excellent book, "Design of Accounts,"[1] and also to the Incorporated Accountants' Research Committee under whose authority it has been published. Sincere thanks are also due to the distinguished Chairman of the Research Committee, Mr. Bertam Nelson, whose restless soul ever drives him into the vanguard of the forces of progress.

This book represents an invaluable contribution to our professional knowledge and technique. Mr. Basil Smallpiece recently reminded us "that the essence of professionalism—that is to say, the real as distinct from the conventional connotation—lies in the holding in trust for society of a specialized technique and body of knowledge; and the responsibility of those engaged in a profession is always to see that the knowledge and the technique are developed for the common good, and are neither polluted nor misused, even at cost to oneself." All will agree with this apt definition, but some will feel very doubtful whether the profession has, in the past, done all that it should have done to build up and establish an accepted technique and body of knowledge for the assistance and guidance of its members.

INDIVIDUALISM IN THE PROFESSION

The profession of accountancy is a very young one. It has been so successful and has developed so fast that the great majority of its members have been completely preoccupied with the conduct of their individual responsibilities; in consequence, the profession has developed upon entirely individualistic lines. Having qualified, each member has travelled on life's journey and from his personal experiences has built up his own technique and body of knowledge. Thus, accountants have become, to a high degree, individualists, which is immediately apparent whenever they meet to discuss any matters connected with their professional technique. This, it is submitted, is also the basic reason why practice differs so widely, to the bewilderment of society.

It is not surprising, in fact, it was inevitable, that development should have been so completely individualistic in character, as until the Society in 1937 set up its Research Committee and in 1942 the

[1] Design of Accounts. By F. Sewell Bray, F.C.A., F.S.A.A., and H. Basil Sheasby, A.C.A., A.S.A.A. Published for the Incorporated Accountants' Research Committee by Oxford University Press. Price 12s. 6d. net.

Institute its Taxation and Financial Relations Committee, the profession had not established any bodies for the development of research and education comparable with the research departments of Universities. In consequence, no provision was made for the building up of an accepted technique and body of scientific knowledge. In recent years the profession has felt the need for a pause to think out many of the problems that have been perplexing each one of us. Further, the pressure of public opinion has directed the thoughts of accountants towards the development of greater uniformity in our professional technique, in particular regarding the form of presentation of the accounts of companies.

It is for these reasons that the publication of this book is so very timely and helpful. It represents a valuable addition to our professional knowledge in a field that is receiving close consideration at the present time not only by accountants but by the legislature and the general public. Mr. Bray and Mr. Sheasby are to be congratulated upon both the general design of the book and the detail of the text. It is certain that this work will be invaluable to all accountants and students, and, in addition, it will be of great interest to a wide public, particularly to directors and secretaries of companies.

Mr. Richard A. Witty, President of the Society of Incorporated Accountants and Auditors, has written a graceful and thoughtful preface in which he points out that "in recent years, discussion as to the use of accountancy technique has largely centred on two questions, namely: (i) the inadequacy of published accounts, and (ii) the use of accountancy data for management purposes, as a basis of action and not merely as a record of the past." Mr. Witty also states that "it was with these objectives in mind that in 1937 the Research Committee commenced to publish a series of accounting forms which have since been widely used and which have, as a result of practical experience, been developed into the accounts shown in this book." All will agree with his further observation that "within the profession, too, there is need for discussion, particularly between members in practice and members who, through service in industry, are in close contact with the detailed problems of industry."

The Principles of Design

In the first chapter the authors discuss, in an able manner, the principles of design. They point out that "one of the objects which the accurate design of accounting documents has in view is to ascertain those relations between groups of figures by which the course of operations over both short and long periods of account may be interpreted." They also state that "all accounts should have in view both simplicity and a disclosure of information sufficient to enable proper inferences to be drawn. In order that essentials may be readily grasped, the main accounts should be relieved of details that make them difficult to take

in." These maxims are the roots of good design and should be imprinted upon the mind of every accountant. All will agree with the authors' views that "it is the duty of directors to render a plain and intelligible account of their conduct of a company's business . . . It has been well said that the control of business enterprise conducted in the form of public companies requires the publication of adequate and intelligible accounts and that this is but one return for the privilege of limited liability."

The authors wisely stress the great importance of grouping and simplicity. They rightly discard any question of standardization of form, but aim at uniformity of information, uniformity of classification or grouping, and uniformity in the choice and use of terms. Of all things they abhor "uninformative omnibus headings." The benefits of grouping and simplicity are so obvious that it is surprising that so many published accounts are still drawn up in accordance with the old uninformative methods.

Published Accounts

In the past, little attention has been paid to the form of published Profit and Loss Accounts, but Mr. Bray and Mr. Sheasby rightly consider that here also design is a matter of great importance. They stress the importance of showing clearly the operational profit quite distinct from non-operational items, transfers to and from reserves, etc., and also they state that "every effort should be made to show the manner in which the true operational profit is built up." They, therefore, recommend that the following should appear plainly—net sales, cost of materials, labour, works expenses, sub-contracts, selling and distribution expenses, cost of administration and management and cost of finance. As regards the form of published revenue accounts, the foregoing is no doubt the ideal, but accounts upon these full lines could be achieved generally only by amendment of the company law. In this connection it is interesting to note that the Chairman of Imperial Chemical Industries, Ltd., recently disclosed the revenue figures of his great group of companies much upon the foregoing lines, which are, of course, closely in line with standard practice in the U.S.A.

There is one direction in which many readers may feel disappointed and that is as regards the important subject of the accounts of holding companies. Only one paragraph is devoted to this burning question, but the reason may be that this matter is to be the subject of further research. It is hoped that that is the intention and that we may look forward to a publication upon this vital subject which will include suggested forms for consolidated Balance Sheets and Profit and Loss Accounts.

Interpretation of Accounts

A separate chapter of the book deals with the important subject of the interpretation of accounts, which is of particular concern to

the management of a business undertaking. This is a subject that has not received from the profession anything like the degree of attention that it deserves.

The authors, in this connection, give a most helpful description of the use of accounting ratios. Most accountants will agree with them when they state that "in this country the use of accounting ratios is still somewhat of a novelty. . . . It is, therefore, not inopportune to suggest that professional accountants should examine a little more closely this idea of accounting ratios, more particularly in relation to the analysis of Balance Sheets and income statements."

Specimen Forms

The book includes a number of specimen forms of accounts, including a specimen form of a company Balance Sheet as related to the requirements of the Companies Act, 1929. The provisions of the Act as regards the profit and loss account are also given. Students, particularly, should find this information most helpful. There are also specimen forms of published company Balance Sheets and Profit and Loss Accounts, the form of presentation of which is excellent.

Lastly, the book includes specimen forms of accounts for twenty-five specific undertakings, including executorships and trusts. In this part of the book the authors have broken new ground, and it is certain that these forms will be of great assistance to all accountants. The design of these specimen accounts is excellent: they are simple, clear and practical.

In an appendix, there are reproduced the recommendations on accounting principles Nos. I to VI of the Council of the Institute of Chartered Accountants in England and Wales. By this means the recommendations of Mr. Bray and Mr. Sheasby can be compared with those of the Council of the Institute.

The profession will hope that the Research Committee of the Society, having made such an excellent start, will be encouraged to continue its invaluable research work. In view of the vast changes taking place in the world it is urgently necessary that the accountancy profession should make sure that it is fully equipped to meet its ever-increasing responsibilities. It is obviously wise, therefore, for accountants to reconsider and strengthen their specialized technique.

Chapter X

The Interpretation of Accounts

A paper delivered before the Institute of Book-keepers, Ltd., on 23rd March, 1926.

It may be said that the interpretation of accounts is the art of making figures speak, and figures will speak to those who understand the language. All the work involved in connection with the detail records of a business is largely wasted unless the results shown are properly interpreted.

Before proceeding further I think it well to point out that both the Profit and Loss Account and Balance Sheet of a business are based upon estimates. In connection with the Balance Sheet—as regards the liabilities—estimates play a very small part. If the books are properly kept there is no difficulty in ascertaining exactly what the liabilities amount to. There is only one type of liability where estimates come in, and this is a contingent one. For example, if in connection with some contract or transaction a dispute has arisen and litigation is pending, it is not possible at the date when the Balance Sheet is being prepared to ascertain the final result of the transaction. It is necessary, therefore, in this case, to make an estimate. As regards the assets of a business, these have to be valued for Balance Sheet purposes and of necessity these valuations must be based upon personal opinion and judgment. Both the Balance Sheet and Profit and Loss Account are directly based upon these estimates and therefore the Balance Sheet shows the estimated position and the Profit and Loss Account the estimated profit or loss. These facts are not commonly appreciated, and are elements to be considered when perusing accounts.

The important factor with regard to a Balance Sheet is the man behind it. If this individual is prudent, wise, careful and sound in his judgment, then a reliable Balance Sheet will be the result. If he is careless and slipshod, an unreliable Balance Sheet will result, and if he is a rogue, probably a fraudulent one will be presented. Therefore, it is impossible to come to final conclusions in the interpretation of accounts unless one can get behind the accounts, as is the case with a professional investigation. In this case it is possible not only to see exactly how the figures are made up, but to form an opinion as to whether the estimates upon which the accounts are based are sound. The professional accountant will interrogate the individuals responsible for framing the estimates, and in this way can form an opinion as to whether such estimates are reliable or not. Apart from a professional investigation, if the accounts are properly framed there is a great deal of information which can be gleaned from them by means of a proper interpretation.

The need for a detailed interpretation of the accounts of a business arises in various ways. Obviously, it is necessary for the management of the business to read their accounts, and in this way to obtain all the information possible, not merely from the point of view of what has happened in the past but because the history of the past is a guide for the future when deciding policy and in preventing waste, mismanagement and weakness.

If a business man is considering the purchase of a business, joining a firm as a partner, lending money, or granting extended credit, one of the first things he will do, if he is wise, is to ask for the production of the accounts of that business for a period of years, in order that he may ascertain the position of the concern. It is very common in these days also, to call for a professional investigation of such accounts.

In order to interpret the accounts effectively, it is necessary to have the figures for a period of years. The accounts for one year alone will give information, but they will not carry one very far. If, however, the figures are available for a number of years, it is then possible to see the trend or movement, that is to say, whether the position is steady, expanding, contracting or fluctuating. Assuming that the accounts of a business are available for four or five years, the figures should be re-cast and set out in columnar form and against each column percentage calculations should be inserted. If the figures are set out in this way, every fluctuation or variation can be seen at a glance.

Dealing first with the revenue side of the business and assuming it to be a manufacturing concern, there are three distinct departments: firstly, the manufacturing side, secondly the selling side, and thirdly the administrative side of the business. Each of these three departments must be efficient if maximum results are to be obtained. It is of little use to manufacture efficiently if the selling side of the business is weak; on the other hand, the selling side cannot be effective if the standard of the production does not meet the requirements of the market.

The administrative side is responsible for the general administration of the business, and here again efficiency is essential.

Taking first the Manufacturing Account, as explained, the figures for a period of years will be set out in columnar form under the following headings—

(*a*) The cost of the materials used during the year or period.

This figure will represent the opening stock of materials plus purchases, less the closing stocks.

(*b*) Productive labour.

(*c*) The factory overhead charges.

These will include all expenses in connection with the factory such as power, lighting, heating, plant maintenance and depreciation, general labour, factory rent, rates, taxes, etc.

To the total arrived at as above will be added the cost of the work in progress at the commencement of the period, deducting the cost of the work in progress at the end of the period. The final total will represent the cost of the work completed during the accounting period.

If in the business there is only one unit of production, then each item in the Manufacturing Account can be divided by the total number of units produced during the period, and worked out, therefore, as the cost per unit. If, however, there is a variety of production, then the various items commonly are calculated as percentages.

An examination of the figures for a period of years, set out in this way, will give valuable information as regards the manufacturing side of the business and the variations and fluctuations can be seen at a glance. If the manufacturing side is efficient, the tendency should be for costs to reduce and by an efficient and sound buying policy the cost of materials may be reduced. By effective works management waste of labour can be eliminated. Naturally, both of these figures may be affected by fluctuations in prices and labour rates, and this will be reflected in the accounts.

As regards the overhead charges, these require careful scrutiny. With an old-established business there is always a tendency for the overhead charges to increase, but by effective supervision economy can be obtained consistent with true efficiency.

In examining the Manufacturing Account it should be noted from year to year what proportion the factory overhead charges represent to the prime cost, and whether this ratio is rising or falling.

Turning to the trading account proper, or the selling side of the business, the factory cost of the completed work in total is debited to the Trading Account and the sales less returns credited. At the same time, sales stock at the beginning and end of the period is debited and credited to the account. The Trading Account thus shows the gross profit or loss on the total sales for the period. Obviously, in examining the trading accounts one would look to see whether the turnover was expanding, contracting or fluctuating. The amount of the returns is important, as if the proportion of returns is increasing, it is an unhealthy sign and may indicate faulty manufacture.

The gross profit for each year should be worked out as a percentage of the turnover and the percentages from year to year should be carefully scrutinized with a view to seeing whether the percentage of gross profit is sufficient to cover the selling and administrative charges, and whether this percentage shows a tendency to increase or decrease.

In studying the trading accounts it may be found that the turnover is falling, in which case it is necessary to endeavour to ascertain the cause. It may be that the selling side of the business is not working efficiently: it may be faulty manufacture, bad trade, or that selling prices are too high. In such circumstances it is most important that the management should go into the whole question thoroughly and upon

ascertaining the facts they must decide their future policy; it may be sound policy to reduce prices on order to increase the volume of production. The gross profit or loss will be carried down to the Profit and Loss Account, which will be credited with any miscellaneous income and debited with selling and distribution expenses such as travellers' salaries, commission and expenses, advertising, discount, bad debts, carriage and freight. The whole of these items should be in one group. The second group would comprise all the administration charges of the business.

The selling charges should be worked out as a percentage to sales and this percentage compared from year to year. The selling and distribution charges may be increasing, but this is quite satisfactory if there is a proportionate increase in sales. It is, however, a very unsatisfactory position if selling and distribution charges are going up and sales are coming down. It is possible for considerable sums to be expended upon advertising with very small results, if we do not advertise in the right and most effective way.

The distribution charges should be examined in detail and all fluctuations noted and inquired into; and these items, again, should be worked out as a percentage to sales.

The final result of the Profit and Loss Account, of course, is to show the net profit or loss, and the trend of these figures from year to year should be carefully noted. If net profits are shown it should be calculated as to what yield these profits represent upon the capital employed in the business. For instance, a net profit of £5,000 would be very satisfactory on a capital of £20,000, but a similar profit upon a capital of £1,000,000 would be a very poor result indeed. To justify itself, a business should show net profits which represent a fair yield on the capital employed.

In studying this side of a business one is endeavouring to ascertain the general nature of the concern and whether it is steady, expanding or contracting. When studying these accounts for a period of years, it is necessary to bear in mind whether there have been any exceptional circumstances in any of the periods, such as a trade boom or exceptionally profitable contracts, or, on the other hand, a trade slump or exceptionally unprofitable contracts. These factors must be borne in mind in gauging the future prospects of the business based upon its past results. In some cases there are important factors which may materially affect the future results. For example, if a business is exploiting a new patent, its earning capacity may be seriously affected upon the expiration of the patent. In the same way, some businesses are very dependent upon the situation of their premises, and if they only hold a lease the earning capacity may be seriously affected upon the expiration of the lease. In some cases the personal influence of the proprietors is a large factor in the revenue earning capacity of the business as a whole, and a material fall in profits may result on the death or

retirement of the leading personality in the concern. In studying the accounts of a business, therefore, with a view to gauging its future prospects, it is most important to bear such factors in mind.

Turning now to the Balance Sheet. Here again the figures should be re-cast upon a uniform basis and set out in columnar form, so that the trend and movement may be readily seen. The fixed assets should be set out as one main group showing the total under this head. The second group should be the current assets and the third group should show unrepresented expenditure, such as preliminary expenses, underwriting commission, discounts on an issue of debentures, debit balances on Profit and Loss Account, etc. On the other side of the Balance Sheet, again, there should be three groups, firstly, fixed capital. This is permanent capital, such as share capital and long-term debentures. The second group should comprise current liabilities, such as trade creditors, bills payable, short-dated loans, bank overdraft, etc.; and the third group should comprise undistributed profits—that is, the general reserve and a credit balance upon Profit and Loss Account.

It is a common practice in America to set out the Balance Sheet figures in this form, and shown in this way essential factors are clearly revealed as regards the financial position of the business. For example, one of the most important points as regards any Balance Sheet is the ratio of curr[illegible] and the trend of this ratio from year to [illegible]

The position is that a business starts with a certain amount of fixed capital and a proportion of this becomes locked up in fixed assets, but a sufficient amount of working capital must be left to finance the business operations.

In studying the Balance Sheet as re-cast, it can be seen at a glance what is the amount of the fixed capital, how much is represented by fixed assets and what is the amount of the working capital which is represented by the current assets less current liabilities. If the ratio of current liabilities to current assets is rising, this is a danger sign and may indicate over-trading. In boom times, such as happened after the late war, over-trading is very common and may have most disastrous effects subsequently. This position may arise in this way—trade is very brisk and orders are pouring in, and the management may well feel that this is the time to reap the harvest. In order to expand the turnover it may be necessary to enlarge the works and purchase additional equipment and the total capital invested in fixed assets therefore rises. If further fixed capital is not raised, the result must be that the working capital is encroached upon. If the boom continues it may well be that the turnover rapidly expands, but in order to cope with this a larger working capital is necessary as stocks and book debts increase proportionate with the expanding turnover. In these circumstances the business of necessity will have to stretch its credit to the limit and probably an increasing bank overdraft and a material increase in the

total of the current liabilities will be the result. During the continuance of the boom it may well be that large profits are shown by the accounts, but after the boom comes the slump, when the business may find itself in a most precarious position.

The probability is that large stocks are held, but prices are falling rapidly and great difficulty is experienced in selling the stocks, and serious losses may result. The customers of the business will also be affected by the slump, and difficulty will be experienced in collecting book debts and heavy bad debts may be incurred. The creditors of the concern will also be affected and may commence to press for payment, and, if any of them become uneasy as to the financial position of the concern, they may take legal action. If a large bank overdraft is in existence it may well be that the bank will demand a reduction in the overdraft, and if the bank or any of the creditors do take action, then in such circumstance it may be that the whole business will collapse like a pack of cards.

Over-trading will be reflected in an increase in the ratio of current liabilities to current assets. You will appreciate, therefore, that an increase in this ratio is a real danger signal.

When studying the Balance Sheet figures in more detail it should be seen what are the natures of the various fixed assets and what is the basis of their valuation; this should be cost less adequate depreciation.

In the case of such fixed assets as plant and machinery, the books of account will show the cost, and depreciation rates should be fixed which will write off the cost less any residual value over the estimated working life of the assets. Adequate provision for depreciation is of course an essential factor in studying both the Balance Sheet and the Profit and Loss positions.

The fixed assets may include a wasting asset such as a mine. In mining companies it is a common practice not to provide for depreciation of the mine itself, although, naturally, depreciation is resulting by reason of the fact that the minerals are being extracted. When considering the Balance Sheet position of a mine, if depreciation is not being provided for, an all important factor is the probable length of life of the mine itself.

Goodwill is an item commonly found amongst the fixed assets and the proportion which this item bears to the total fixed assets is important. If you see a Balance Sheet, as I did recently, where the ordinary share capital stood at one million and goodwill at just under that sum, you would be wise to think twice before having anything to do with that company.

Turning now to the current assets, these will consist of bank balances, sundry debtors, bills receivable, stock, work in progress, etc., and the trend of these figures, in detail and in total, should be carefully noted.

With regard to stock, the ratio of stock to turnover should be ascertained and if this ratio is increasing, one should endeavour to ascertain

the cause. An increase in this ratio may indicate inflation of stock values or an accumulation of dead stock; that is to say, out-of-date stock which it is very difficult to sell.

Another important ratio is that of book debts to turnover. There should be a definite ratio and if this is increasing it is an unhealthy sign. It may indicate ineffective collection or that proper supervision is not being exercised as regards the opening of credit accounts. The selling department of a business can easily expand the turnover by the indiscriminate opening of credit accounts, but the inevitable result may be heavy bad debts. If bad debts are to be kept to a minimum there should be careful supervision in the opening of credit accounts and in subsequently watching and collecting the book debts.

Coming now to unrepresented expenditure. Here obviously, it is a question of the nature of these items and the proportions, and whether this total is increasing or decreasing.

Turning to the other side of the Balance Sheet, and assuming that we are dealing with a limited liability company, consideration should first be paid to the fixed capital group. Here it will be seen what is authorized and issued share capital. It should be noted whether the whole of the capital has been issued or not and whether the issued shares are fully paid up or not, as if, for example, the shares are only partly paid, there is a fund which can immediately be called upon to meet the business needs. If there are unpaid calls, and especially if they are considerable in amount, one should endeavour to find out whether they are recoverable. If there are preference shares and they are cumulative, it is wise to ascertain whether the dividends are in arrear and if so, to what extent. This may be a very material factor from the point of view of the ordinary shareholders. If, for example, the preference dividend is ten years in arrear, the prospects probably are not bright as regards the ordinary shareholders obtaining any return in the near future upon their investment. If debentures have been issued this is bound to affect the credit of the concern. One would wish to ascertain whether the debentures give a fixed charge on certain assets or a floating charge over the whole of the assets and also when and under what circumstances the debentures are repayable. If, for example, the redemption date is near at hand, and no sinking fund has been created, the financial position of the concern may be seriously affected when the time for repayment arrives. The money originally received from the debenture holders will have been expended in the business and in all probability it will be impossible to find the necessary cash in the business itself. In these circumstances, in order to repay the original debentures, it would be necessary to borrow from some other source; but, if the business is in a weak financial position, difficulties may arise or it may be only possible to borrow on far less favourable terms.

As regards the current liabilities such as trade creditors, etc., the general trend of these figures from year to year should be noted and, as

already indicated, the ratio to current assets. If there is a bank overdraft it should be shown separately and one would wish to ascertain what security was held by the bank.

As regards undistributed profits, naturally we like to see these steadily increasing. The business which invariably distributes profits up to the hilt does not as a rule have a very long life. The sound business is constantly building up reserves which strengthen the whole financial position of the concern and supply additional working capital with which to finance and expand its operations.

If one were investigating the accounts of a company it would be prudent to call for the auditor's reports—not only to the shareholders but also to the directors—these latter reports being far more informative.

If the accounts of a business are examined on the lines I have indicated, provided that the accounts are honest it is possible to see clearly the general trend and whether it is satisfactory or the reverse. It is possible to see what have been the trading results, what is the Balance Sheet position, whether this is steadily improving or not; but, as I have already said, to be conclusive it must be possible to go behind the accounts, to examine the books and records and to interrogate the officials responsible for the framing of the accounts and the estimates upon which they are based. Only in this way is it possible to form a considered judgment and to come to conclusions as to whether the position shown is a true one or not. If, however, it is not possible to obtain access behind the accounts, if these accounts are properly drawn up and they are honest, there is a great deal of information to be gleaned by interpretation upon the lines I have indicated. There is a tendency for the published accounts of companies to be very much condensed and there are many who hold that they are drawn up so as to give a minimum of information. In some quarters we auditors are blamed for this, but it is not a true charge. The published Balance Sheet of a company is not the Balance Sheet of the auditor, as you often hear it referred to as, but it is the Balance Sheet of the directors. The auditor has no power to alter one figure or word in the directors' Balance Sheet. If he does not approve of the Balance Sheet his first course is to go into the matter with the directors and if they are reasonable and honest they will, as a rule, be advised by the auditor. If the directors refuse to accept his recommendations, the auditor has no power to alter the Balance Sheet; but, if in his opinion the Balance Sheet does not show the true position of the company, then he must deal with this matter in his report to the shareholders. The auditor, however, cannot report to the shareholders that the Balance Sheet is unduly condensed and that additional information should be given.

The weight of public opinion is making itself felt, and the demand is for more information in published accounts. The standardization of accounts is impossible, but in my opinion there is room for improvement

in the form in which published Balance Sheets are presented, and evolution upon these lines would greatly assist in the interpretation of the accounts of commercial concerns.

The policy of secrecy has been over-stressed and in my opinion is unwise, and in the interests of all the various parties in industry, honest and open accounting is, in my submission, the wise policy for the future.

SECTION II

FINANCIAL PLANNING AND CONTROL IN INDUSTRY

Chapter XI

The Place of Accountancy in Commerce

A lecture delivered at the London School of Economics on 14th October, 1926.

The subject I have chosen for consideration to-night is the place of accountancy in commerce. There have been considerable developments in accountancy during the past fifty years and the commercial world is attaching an increasing importance to this part of business organization. Accountancy has also now become an important subject in the modern University commercial course, and in this movement the commercial world is taking an active interest, as is shown by the fact that the chair recently vacated by our distinguished chairman, and to which I have had the honour to be appointed, was endowed by the late Sir Ernest Cassel, who was a most prominent figure in the world of commerce.

The subject of accountancy is a far wider one than is generally appreciated and I therefore propose to describe briefly the ground that it covers, the part which accountancy plays in the management and control of a commercial undertaking and the possibilities for its future development.

The industrial revolution of the nineteenth century witnessed an enormous development in commercial activities and individual business concerns expanded to a size never previously contemplated; the introduction of the limited liability company greatly facilitated the raising of capital for industry and thus provided the funds necessary to finance this expansion.

The great development in communications and transport has brought far distant markets into touch with one another and has thus expanded the international side of trade. On the other hand the commercial development of the world has introduced keen international competition. During the nineteenth century and the commencement of the present century, commercial history reveals an ever growing expansion. The recent war and its aftermath, however, dislocated trade in a way which had never been visualized and created conditions of extreme difficulty, as to which the world of commerce had no previous experience. In consequence of these various factors there can be no question but that the conduct of trade to-day is far more intricate and difficult than ever it was before.

In the course of this process of evolution, the organization of business has had to be altered, expanded and adapted to meet these changing conditions, and experience has shown that an essential part of the organization of a modern business is a sound accounting system. It is impossible successfully to control a business without such a system in the same way that it is impossible to navigate a ship without a chart and a compass. The financial ship of to-day has to be steered through most difficult and dangerous waters.

During the past fifty years accounting methods have greatly developed and the value of accountancy as a part of commercial organization is being felt increasingly. In earlier days business men concentrated upon book-keeping records dealing with their transactions with debtors and creditors and complete systems of book-keeping upon double-entry lines were not by any means common. A stocktaking was effected annually and the assets of the concern were valued approximately, the liabilities deducted and thus the surplus of assets was arrived at. The progress of the business was roughly gauged by noting the increase or decrease in the surplus of assets over liabilities. In these early days the living expenses of the proprietor of the concern and his family generally were all included with the running expenses of the business and no Profit and Loss Accounts or proprietors' Capital Accounts were prepared.

An important factor in the evolution of accountancy was the introduction of the limited liability company, as the Act provided for the appointment of an auditor on behalf of the shareholders. This legislation, together with the great increase in the number of concerns registered under the Companies Acts, were important factors in the rapid development of the accountancy profession. During the past

fifty years an ever increasing number of concerns, for the first time in their history, have appointed professional accountants to audit their accounts. This fact undoubtedly has resulted in the introduction of up-to-date accounting methods in business and has proved to the commercial world the great value of a sound accounting system. Another important factor in the modernizing of the accounting systems in commerce has been the ever increasing direct interest of the State in every commercial concern. The great increase in direct taxation has forced business men to keep proper accounts as a means to a fair assessment to taxation, and the State has brought pressure to bear in this direction.

During the past fifty years the accounts department has become of growing importance, but in my opinion all the possibilities of this organization have not yet been fully realized by the commercial world and there are great possibilities for further development. In this movement the professional accountant is in a position to play an important part, as in his practice he obtains experience of many businesses and their methods. Further, his professional training is directed towards a scientific study of every aspect of this subject. One of the most marked developments in commerce during recent years has been the remarkable growth of the accountancy profession and the increasing reliance which the commercial world places upon the advice of the professional accountant. He is therefore in a position to exercise a powerful influence in the direction of further development, but real progress is impossible until the commercial world itself is convinced as to the great possibilities of accountancy and the great help which it can give to the management of every business concern.

In the past and to a material extent at the present time the accounts department is not regarded as one of prime importance in the general organization of a business. Its functions are mainly concentrated upon recording transactions with debtors and creditors which obviously must be kept up to date, and the keeping of the ordinary system of accounts, leading up to the preparation of the annual Profit and Loss Account and Balance Sheet with a view to ascertaining the trading results for the year and the financial position. In this way the accounts department merely serves the purpose of recording completed transactions and showing in due course what has been the result of the commercial operations of the past. The accounts department under these conditions is merely a book-keeping organization. It plays but a small part in the practical management of the concern and is always looking backwards and not forwards; that is to say, upon the completion of transactions the accountant ascertains the result, but he is not consulted or concerned prior to such transactions being entered into and he has little influence in deciding the future policy of the business.

In such circumstances the work of the accounts department is of a mechanical nature and in consequence a high grade staff is not

essential. The most efficient members of the staff of the business are placed in the executive departments and the accounts department is left with a staff of poorer quality. This position is reflected in the salaries paid. The highest salaries are paid as a rule in the sales department, and the accounts department is the most poorly paid of all.

There are many who are of opinion that there is something wrong with commercial organization in this country to-day and that in order to survive in the difficult conditions which exist, commercial organization must be modernized and strengthened. In this country we have a long commercial history and have through many generations accumulated great experience, but we are very conservative and slow to change our methods.

In my opinion one of the weaknesses in commercial organization generally in this country is in accounting. Already, many important concerns have realized this fact and have reorganized upon modern lines, but in the great majority of businesses, in my view, the accounting systems are old fashioned and quite inadequate to meet present day needs.

Reorganization should be upon the lines of raising the whole status of the accounts department, which should rank equally with the principal executive departments. The chief accountant should not be merely the head book-keeper but he should be the chief financial officer of the concern, being responsible to the general manager for the whole of the finances of the business and its financial control. To fulfil these functions the highest grade staff would be essential. In fact, the need is for brains in the accounts department. The chief accountant should not only be master of the technicalities of accounting but he should have a wide knowledge of business organization, business generally and finance, and further, it would be necessary for him to have a highly trained staff under him.

The chief accountant should be directly responsible to the managing director or general manager for the whole accounting organization and he should represent finance, it being his duty to report upon the financial aspects of every proposition under consideration. The chief accountant should be the financial adviser of the managing director or general manager and should be present at all staff conferences. His position should be equivalent to that of the Chancellor of the Exchequer of a government.

In practice the accounts department commonly serves merely the purpose of recording transactions and is quite distinct from the financial control of the business, whereas accounting and finance should be merged and no executive action should be taken until the whole financial aspect has been investigated and reported upon by the accounts department. In this way many pitfalls can be avoided and the accounts department can render most valuable service to the chief executive officer and to the heads of the other departments.

Finance is the basis of commerce and yet in the organization of the majority of businesses there is no specific financial voice. The managing director or general manager, the heads of departments and the directors are expected to be financial experts, whereas often, in fact, they have not had any training in this branch of commercial organization and many of the glaring mistakes made in business undoubtedly are due to the fact that the financial aspects of transactions entered into have not been fully investigated and considered and it is only after the event that the pitfalls are revealed by the accounts. There have been many glaring instances of this in recent years, when disastrous errors could have been avoided had the projects been carefully considered from the financial point of view before action had been taken. Too often the accounts department is concentrated upon the endeavour to whitewash the disastrous errors of the past.

In the old days of privately owned businesses the proprietor was risking his own capital and therefore he considered the financial risks carefully. To-day, by far the greater proportion of businesses are limited liability companies and in consequence the management are not trading with their own capital but often mainly with the capital supplied by outside shareholders. In these circumstances it is most desirable that there should be a strong financial control. Many of the disastrous mistakes which have been made in business in recent years would not have been committed had those responsible been risking their own capital in the venture, or if the financial aspects had been thoroughly surveyed. A careful study of company flotations, bonus distributions, increases of capital and conduct generally during the boom time after the war leaves one gasping at the reckless folly of many of these transactions.

In every large business, therefore, there should be a principal officer representing finance, and finance and accountancy should be combined, as they are inseparable. The chief financial officer should control the whole of the accounting organization, as it is essential that the accounting records should be designed to supply him with the information that he requires. In fact, he can only meet his responsibilities if he has under his control a complete and effective organization.

In the accoun[illegible] there is accumulated an enormous amount [illegible] alue to the management, but in the majority of cases this information is not focused and is therefore not available to those controlling the concern. The reason for this is that manageme[illegible] the value of a scientific organization and the help [illegible] As a rule the principals have had little, if any, accountancy training; in fact, it is remarkable to find how many men holding important positions in industry are, from an accountancy point of view, illiterate. Many of them cannot even read a Balance Sheet. It is not therefore surprising that they do

not see the need for modernizing their accounts department, for even were this done, they would not be able to use it.

These facts are being realized in the commercial world to-day and there are many of the leading concerns in this country which have entirely reorganized their accounting systems upon modern, scientific lines and amongst them are some of the most successful concerns in the country. I think it is safe to say that no business which has done so ever dispenses with this type of organization; in fact, experience shows that ever increasing uses are found for it and the system is constantly expanded.

The part which the accounts department should play in the modernized commercial organization is far wider than is generally appreciated. The principal functions of the accounts department of a manufacturing concern should be as follows—

1. The control of the whole of the book-keeping records, which should be organized upon modern time-saving methods.

2. The control of the stores and costing system.

3. The control of a statistical system the objects of which are to record and focus all information of use to the management.

4. The preparation of weekly and monthly statistical summaries, including monthly Revenue Accounts and Balance Sheets.

5. The chief accountant should be responsible for the preparation of forecasts of the future requirements—for example: materials, labour, equipment, and capital.

6. The accounts department should supply the various executive departments with the accounting and statistical information required by them.

7. The preparation of the annual Manufacturing and Profit and Loss Accounts and Balance Sheet of the concern and reporting thereon to the management.

8. The settlement with the Revenue of the taxation liabilities of the concern.

9. The control of the financial administration of the business and the reporting upon the financial aspects of every proposal under consideration by the management.

10. The chief accountant should act as financial adviser to the managing director and should report to him the important factors revealed by the accounting and statistical records.

11. The accounts department should be constantly engaged upon research work and should report upon the present position, future prospects and suggestions as to improvements in the organization with a view to the economical and efficient conduct of the business.

The book-keeping systems in use in this country are commonly very old fashioned and management does not realize how greatly such systems can be improved and how much time can be saved by modern

methods. The introduction of office machinery alone speeds up the whole of the book-keeping work and at the same time increases its efficiency. Too often the money spent upon the accounts department is regarded as non-productive, whereas this organization will, if effective, pay for itself over and over again. The records must be complete and always up to date and further, they must be so classified that all the essential factors are clearly focused, so that every important aspect of the affairs of the business can be watched. By means of scientific organization upon modern lines, these results can be attained with a minimum expenditure of labour, provided that a thoroughly efficient staff is employed under the control of a competent chief accountant.

In organizing the accounting system of a business the possibilities of fraud must not be overlooked, and it is a comparatively simple matter to graft into the organization what are known as internal checks by means of which the work is split up into sections, the various sections acting as a check upon each other. By these means it is possible to make it very difficult for serious frauds to be perpetrated and to remain undetected for any length of time, unless there is collusion.

In recent years the importance of costing has been realized, but there is room for considerable improvement in the methods as generally adopted in this country. A costing system which does not give accurate results is worse than useless; in fact, it may prove to be a great danger. In these days of severe competition, both at home and abroad, a reliable costing system is a vital necessity to a manufacturing business. Costing is a highly technical and involved matter in many cases and the organization of the system requires considerable skill and thought. It is not purely an accountancy problem. To be successful the co-operation of the technical officers of the concern is absolutely necessary. Further, it is not only essential that the system shall be complete and efficient, but it must be carried out rigidly in practice.

Often, in practice, the systems adopted are basically unsound and incomplete. Of necessity, therefore, the results are inaccurate. In such circumstances commonly the manufacturer becomes most dissatisfied with the results and comes to the conclusion that costing is of no value. It is the particular system which is at fault and if the results are not accurate it certainly is of no value and all the time and labour expended have been wasted.

Costing systems can be made too elaborate and great skill and experience is necessary in the organization of a system which will give accurate results in a clear and simple manner. There is no question, however, that in all cases a reliable system can be evolved and that accurate costing is of the greatest value to management.

Speaking generally, costing in this country in my view is not satisfactory and considerable development is necessary in order to place it upon a satisfactory footing. There is a great need for scientific education and if the manufacturers of this country are to maintain

their place in the markets of the world, far greater attention must be paid to this subject than has been the case in the past.

An essential part of any costing system is a reliable stores system and here again it is common to find weakness. The costing cannot be accurate if the stores system is unreliable. Further, the introduction of a sound stores system which prevents leakage and enables the whole stores position to be watched, controlled and regulated, may well increase the profits of the business to a material extent.

In practice it is not uncommon to find the costing system separated completely from the accounts department, but they should be interlinked and therefore the costing department should be under the direction of the chief accountant.

It is only in recent years that the value to a business of a statistical system has been realized, but, speaking generally, this type of organization is the exception rather than the rule and is in the early stages of development only. But in many concerns there are great possibilities. In the accounting system every single transaction is recorded and there is therefore stored up in this way a great mass of information. The classification in the books of account, however, is designed merely to show the position of affairs as regards individual debtors and creditors, etc., and to give the particulars necessary for the preparation of the annual accounts of the business.

There are many important aspects that are not focused up by the ordinary system of accounts, but by grafting on the accounting organization a statistical system, it is possible, without a material increase of labour, to expand greatly the amount of information available and in this way to record and watch important factors in the affairs of the concern. If a business is to be carried on with the maximum of efficiency and economy, and the management is to exercise effective control, it is necessary to have complete information upon every important factor. The object of a statistical system is to supply this information and by means of clearly drawn statistical statements and diagrams to watch every important factor in the operation of the business that is not already focused in the ordinary book-keeping and costing systems.

To be of any real value the statistics must be constantly up to date so that complete information is always available and should any adverse movements be revealed, corrective action can be taken as quickly as possible. It is in this direction that the whole accounting system so frequently fails in practice. It is of little value to show the results of adverse factors long after the movement has developed, and the damage has been done, but if an adverse trend is immediately revealed, it is possible often to take steps to avoid almost entirely or at least to minimize the final effects.

Considerable skill and judgment are required in order to organize an efficient system. It is easy for the statistics to become over-elaborate

and for useless information to be recorded. The endeavour should be to record only important information and to set the same out in as clear and simple a manner as possible. If this is done the statistical section will prove of the greatest value to management, as it will expand enormously the information available upon every aspect of the affairs and it will enable a far more effective control to be exercised.

The general practice in the past has been to prepare yearly or half-yearly the accounts of a business with a view to ascertaining the financial position and the results of the trading operations. But the commercial world is now beginning to realize that a yearly or half-yearly review is not sufficient. Great changes and important developments may occur in such a long period; it is therefore vitally necessary that there shall be means by which the trend of affairs may be closely watched during the whole of the year. One of the main objects of a statistical system is to supply weekly or monthly summaries, so that every important aspect may be watched closely. For the same reasons many up-to-date concerns prepare monthly Balance Sheets and Revenue Accounts, so that the whole financial position and trading results may be reviewed. In this way a far more effective control can be exercised and many dangers can be averted.

It is obviously sound that the statistical section should be under the control of the chief accountant, as this work is inseparably interlinked with the accounting and financial administration. The accounts department should be responsible for supplying the managing director or general manager with all the information he may require and it should also furnish all the various departmental heads with all the accounting and statistical data required by them. This information should include forecasts of the future requirements of the business such as materials, labour, equipment and finance; particularly is this important if large commitments have been entered into which will increase materially the normal requirements under these heads.

An important function of the accounts department is the preparation of periodical Balance Sheets and Revenue Accounts and this requires not only technical knowledge but also sound judgment. The form in which Balance Sheets and Revenue Accounts are presented is capable of considerable improvement. This subject is well worthy of careful consideration by the commercial world with a view to presenting accounts in as clear a manner as possible.

Published Balance Sheets are often so condensed that it is impossible to ascertain from them the true position. For example, a large American corporation showed an item—

> "Plant, property, equipment, machines, patents, goodwill as per books after deducting surplus of subsidiary companies acquired at organization £28,000,000 odd."

In this case, in fact, 50 per cent of this total was represented by patents and goodwill, but it was not disclosed by the Balance Sheet

that half of this huge total was represented by capitalized earning power.

Balance Sheets drawn up on these lines are quite valueless to shareholders or anyone else who wishes to arrive at the true financial position of a company.

The argument is commonly put forward that it is dangerous to reveal to trade rivals the detailed position of affairs, but how can competitors use this information to the detriment of such a company and how is it that many companies do publish detailed Balance Sheets and yet apparently suffer no damage thereby?

Shareholders are entitled to know the true position of affairs—as to how their capital is invested and whether the capital of the company is being kept intact or not. It is a great shock to the investing public when, as was the case recently, a new board of directors report that some £6,000,000 of a company's capital has been lost.

There is no standard form of Balance Sheet, but accountants are agreed as to the basis upon which Balance Sheets generally should be prepared and the information that should be given. A much debated subject, however, is the question of the Balance Sheets of holding companies. There is no question but that many such companies publish Balance Sheets which give no indication whatever as to the true financial position of the concern.

The whole question of the form of published accounts is well worthy of study and there is no doubt that public opinion is strongly directed towards obtaining fuller and franker accounts. In my opinion this is right and it is in the interests of all parties in industry that the true economic position should be ascertained.

There have been many instances on the one hand of disastrous failures which had not been indicated by previously published accounts of the company and on the other of companies that have accumulated large secret reserves and in consequence the published Balance Sheets have represented a material understatement of the financial position. That such should be the case cannot be considered satisfactory.

The ascertainment of profits in industry cannot be said to be upon a satisfactory basis. In particular the methods adopted for arriving at the provision for depreciation of wasting assets, mineral deposits and goodwill are most unsatisfactory and unscientific. In the majority of cases the whole of the capital expended in the acquisition of plant, machinery and other equipment is merged into one or two accounts and an arbitrary percentage to cover depreciation is written off the balance. Of necessity the individual items of plant making up these totals have widely different working lives and in consequence the amounts written off for depreciation are a mere guess. In view of the great proportion of the capital in industry which is invested in wasting assets, this question is one of great importance and it is one which should receive the closest attention of the commercial world. As regards the treatment in

accounts of mineral deposits and goodwill, there is no established practice, and in fact these important matters are dealt with in a most haphazard and unscientific manner.

Owing to the unsatisfactory way in which capital expenditure under these heads is dealt with in accounts, the true profits of industry are not revealed by the annual accounts. This fact undoubtedly gives rise to many false conceptions and in view of the steadily increasing demand for a greater knowledge of the state of industry, it is, in my opinion, a matter of vital importance that accounts should be prepared upon a far more scientific basis than heretofore and that every effort should be made to arrive at the true economic position of every business.

The passing of the accounts of a business with the Revenue for the purpose of agreeing the Income Tax assessments is in many cases a complicated matter and requires a complete knowledge of Income Tax law and procedure. It is a common practice nowadays to place this work in the hands of the auditors of the concern. There are considerable advantages in this matter being handled in this way and this course is encouraged by the Revenue, but even if the settlement of the assessments is left in the hands of the auditors, it is desirable that the chief accountant should have a sound working knowledge of taxation matters. Circumstances often arise where it is prudent to consider carefully before taking action the effect upon taxation. Often in practice executive action is taken without considering the matter from this point of view and it is afterwards found that considerable saving in taxation could legitimately have been effected had the matter been handled in a different way. It should therefore be one of the functions of the accounts department to watch this aspect of affairs.

The accounts department should represent the financial control of the business. Instead of merely looking backwards the accounts department should be constantly looking forward in the endeavour to forecast the future trend of affairs. The records of the past should be used as a guide to the future. If the chief accountant is capable and he has an efficient and complete organization under him, he should be able to give sound advice to the chief executive upon the financial aspect of affairs and no important transactions should be entered into or policy decided until the chief accountant has advised as to the financial considerations involved. Only too often in practice action is taken which the accounts department subsequently show to have had disastrous results which would never have occurred had the matter been considered from the financial aspect in the first place.

The accounts department should be constantly engaged upon research work, not only with a view to detecting weakness and waste, but with a view to putting forward suggestions as to methods by which greater efficiency can be attained and how errors of the past may be avoided in the future. The chief accountant should be able to show at

any time the exact economic position of the business and point out the present and future difficulties and dangers. By sounding a timely note of warning many dangers may be avoided and this should be one of the most important functions of the chief accountant.

I do not wish to give the impression that I am suggesting that the accounts department is the most important of all and that it should be responsible for the practical management of the concern. The accounts department should be the servant of management and its purpose should be to watch and advise upon the financial aspect of affairs, and in this way to assist the management in the control and administration of the concern.

The auditor is commonly blamed for many of the defects in accounting methods and practice, but whereas he is in a position to advise, he has no power to bring about a reorganization, however much he may deem the same to be desirable. Reorganization must come from within, and therefore, before real progress can be made, the commercial world must be educated to understand the needs and appreciate the possibilities and uses of modern accounting methods.

I am convinced that many of our difficulties to-day would be overcome if every commercial concern had a thoroughly efficient accounts department organized upon modern lines. Were this the case continuous research work would be carried on and we should accumulate a far more complete and accurate knowledge than exists to-day of the true economic position of industry.

The successful control of any business must be based upon organization and the accountant should stand at the centre of the system. Although accounting methods have been developed greatly in the last generation, there are undoubtedly great possibilities for improvements and further developments.

One of the great problems of to-day is the balancing of the interests of the various parties in industry—that is, labour, management, capital, the consumer and the State. The accountant should be able to render valuable assistance in finding the solution to these problems and be able to dispel many of the misconceptions that exist to-day which are based upon ignorance of the true facts.

I have endeavoured to show in broad outline what the subject of accountancy embraces, the place it should take in commerce and the possibilities for development, and I hope that I have convinced you students, who will shortly be taking your place in industry, that this is a subject well worthy of study. If you bring into industry a sound and complete knowledge of accounting, of its possibilities and uses, then it is certain that real progress will be made in the development of this important part of commercial organization. The Universities can render great service to industry and commerce by a scientific study of these problems which those actively engaged in the stress of modern business often are unable to devote time to. In this movement, under

the able guidance of Professor Dicksee, this School has already accomplished a great deal and it is for us who follow to make every endeavour to continue that great work so that from the London School of Economics industry may draw young men and women who will be able to play a worthy part in the industrial and commercial life of this old country and of the great new countries of the world.

Chapter XII

Accounts as an Aid to Management

A paper delivered before the Office Machinery Users' Association on 9th November, 1927.

I PROPOSE to-night to outline what is involved in the management of a business and to consider what assistance can and should be afforded by the accounts department.

The present is a period of reorganization and adjustment in industry. As a result of the great war, conditions have changed entirely and men's minds are concentrated upon the whole problem of industrial reorganization. Great changes have already been effected and it is certain that this process of evolution is destined to continue.

In the course of this searching investigation it has become clear that the individual business unit does not stand alone, but that it is directly affected by countless other concerns and by factors originating often in far distant parts of the world. As, therefore, by force of circumstances attention has had to be focused upon the study not only of the individual business unit but upon industrial and commercial organization upon national and international bases, it has become vividly clear how great a part management plays in the fortunes of industry.

It has become obvious, therefore, that it is of vital importance that the whole science of management should be studied from every angle. No business can succeed with faulty management at the top and there is little doubt that in many organizations this is where the fault lies.

If, therefore, the industries of this old country are to be revived and attain their pre-war strength and proportions, it is essential that the best brains available should be concentrated upon the problems of management and reorganization.

In the old days, it was commonly held that there were only two parties in industry—i.e. capital and labour, but there is a third—management, and in addition there are the consumer and the State.

The large industrial enterprise is a comparatively modern development which has complicated the problems of management considerably, with the consequence that the management of a large industrial unit necessitates a great amount of scientific and technical knowledge and skill, combined with powers of leadership, inspiration and imagination.

In the past, the large proprietary interests *ipso facto* constituted management, but it is being realized to-day that management is a separate science, and that it is in the interests of all parties in industry

that those responsible for management should be appointed solely by reason of their personal and scientific qualifications. One of the great problems of the present time is to find men who have the necessary knowledge and qualifications to shoulder the great responsibilities of management.

In some quarters the term "scientific management" is regarded with the greatest suspicion, on the grounds that it is merely a cloak to hide the attempt by capital to strengthen its hold upon industry with a view to the exploitation of labour and the consumer. This view is entirely erroneous, as whether an industrial enterprise is owned by the capitalist, the workers or the State, the vital need for efficient and competent management remains the same.

In an industrial enterprise there are two main functions—i.e. production and marketing, and each of these has several subdivisions. Production involves the provision and maintenance of the necessary plant and equipment, works and plant lay-out, the purchasing of materials, the provision and control of stocks, the provision and control of labour, design, production, planning and control. Marketing, on the other hand, involves the selling and distribution of the production.

A further function is finance, which involves the provision of the capital necessary to acquire the plant and equipment, the working capital required in order to finance production and marketing and the general financial supervision and control.

These various functions are subdivisible into many distinct subsections and the functions of management are to co-ordinate and control the whole of these several divisions and sections of the whole organization, as only in this way can maximum efficiency be attained.

An essential factor in the efficient management of a business is balance and rhythm throughout the whole organization and it is the function of management to attain this. The various departments may be likened to the separate oarsmen in an eight-oared boat. Balance and rhythm are essential and, further, stroke must set the time. In the industrial boat stroke is represented by the sales division and all other divisions and sections must be timed accordingly. Therefore, plant capacity, buying, production, design, stocks and finance, etc., must all be balanced to the sales volume and requirements. Otherwise, disorganization and financial disaster may well follow. In the case of a concern manufacturing a number of different lines, unless there is correct balance, over-production may occur in certain lines, thus piling up excessive stocks resulting in the locking up of working capital and commonly loss on realization. On the other hand, in the case of lines that are selling actively, if production lags behind, stocks will run out, resulting in loss of orders and dissatisfaction of customers. In order that production may keep time, the buying department must keep pace in the provision of raw materials, stocks must be kept at balanced levels, excessive stocks may result in serious losses, and on the other

hand running out of a particular stock will hold up production and may have disastrous consequences.

Production may also be seriously hampered by lack of special tools, gauges, drawings, labour, packages, faulty workmanship, labour troubles, faulty materials, breakdown of plant and many other factors.

Plant capacity must be balanced to sales volume, as idle plant increases costs and may have serious results.

In the past, production was regarded as the main function, as it was held that if production was right the goods would sell themselves. In this country, the standard of production is of the highest quality, but goods do not sell themselves. In my opinion it is marketing which commonly is the weak spot in industrial organization in this country. The problems of marketing cover a very wide range and marketing, to be successful, must be scientific, thorough and aggressive. The basis of industrial enterprise is service to the consumer, a fact which we often overlook.

Marketing will be adversely affected by faulty design and therefore the design section must be in close contact with market requirements. This problem is of especial difficulty in the case of commodities affected by fashion.

One of the most common causes of serious loss is lack of effective stock control—i.e. of stores, raw materials, work in progress and finished stocks. Experience upon this point was purchased at a huge cost in the great slump after the late war and, in consequence, management is deeply concerned in devising means by which stocks may be properly controlled and regulated to keep pace with marketing.

A vital part of industrial organization is the human factor—i.e. the provision of the right type of labour, scientifically trained and working under proper conditions. First-class work can only be obtained with the right type of labour, working in the right way and efficiently led; a contented and interested labour force is a prime factor in industrial efficiency. Labour relations is one of the most difficult problems with which management is faced at the present time.

Finance is the basis of industry and therefore the scale of operations must be governed by the capital available; financial control must be complete and effective and every effort directed towards the elimination of waste in production, marketing, administration and financial costs, as well as in the cost of equipment. With efficient management, great reductions in costs can be effected, but constant scrutiny and effective control are essential.

A difficult problem which management has to face is business forecasting. Production must be in advance of marketing and it is this which introduces the risk factor, which is inseparable from industrial enterprise. Before goods can be marketed they must be manufactured; therefore, materials must be purchased, plant and labour provided.

The production process may span a considerable period, with the result that when the goods are ready for the market, demand may have changed or price levels fallen. These are the normal risks of business but success will depend upon how accurately management has forecasted demand and price tendencies. Management must therefore be ever looking ahead, forecasting the future and planning accordingly; only in this way can the industrial ship be safely navigated. Management is concerned not so much with the present position of affairs but with the future—i.e. what will demand be and what will prices be six months ahead? And success will depend upon how nearly the future has been forecasted. There can be no more dangerous policy than trusting to luck; but far too many businesses are managed without scientific forecasting and forward planning. To be successful, management must plan ahead and it is better to have miscalculated than to have no plan at all.

The foregoing is merely a sketch in broad outline of some of the functions of management and these may be summarized as follows—

The provision of the necessary works and plant scientifically laid out, with a view to the elimination of waste in all directions.

The provision of plant capacity which must be based upon forecasted demand.

The provision, training, supervision and welfare of labour, both skilled and unskilled.

The provision of the necessary stores, materials, tools, drawings, patterns, gauges, etc.

The regulation and control of stocks of stores, materials and finished goods.

The regulation and control of the production programmed.

The marketing of the finished goods.

The financing of the whole enterprise.

The provision of the necessary administrative staff.

The fixing of policy and future plans which must be based upon forecasts.

The control and co-ordination of the whole organization, with a view to attaining balance and rhythm.

The elimination of waste in every direction in order to attain maximum efficiency.

The exercise of powers of leadership and inspiration and the maintenance of discipline.

In short, the aim of management is to produce the right goods at the right price and to market them at the right time and in the right way.

Apart altogether from the factors which arise within the concern itself and which management can control, there are other important factors which originate outside and which are beyond management's control.

Every business is affected by the trade cycle. Economists have long endeavoured to find the cause of this ebb and flow in industry, but, whilst the causes are obscure, the fact remains that these ups and downs do occur in cycles and they vitally affect every industrial and commercial concern. The trade boom is invariably followed by the slump, when prices and wages fall heavily and the concerns carrying heavy stocks make great losses upon their realization. One has merely to study the history of the great slump in 1920 to appreciate the disastrous effect the fall in the trade curve had upon industry. Economists are endeavouring to find means by which the trend of the trade cycle can be foretold and they have already made great progress; the boom in 1919 and the slump in 1920 were in each case forecasted some months before these movements developed. It would obviously be of enormous value to every business concern if the general trend could be foreseen and in this direction economists could render incalculable service to industry. Management must appreciate the possibilities and make use of all economic material available.

An industrial concern is directly affected by the economic conditions in the particular industry to which it belongs and by the conditions in other industries. If in a particular industry production outstrips demand, the market becomes flooded, prices must fall and thus every concern in that industry must be directly affected. One of the great industrial problems is how to balance production with demand. Again, if conditions are bad in a particular industry, the purchasing power of all those employed in it is reduced and thus, automatically, the demand falls for the production of other industries. For example, if the American cotton crop fails, the cotton industry in Lancashire is adversely affected and thus the purchasing power of all the workers in that great industry is curtailed and in consequence the demand for clothes, boots and other necessities of life falls.

In the same way labour troubles in one industry affect others and bad trade conditions in one country adversely affect the trade of other exporting countries.

It will be appreciated, therefore, that management, apart from watching and controlling a particular industrial unit, must keep in close touch with the economic conditions in other industries and other countries as these outside factors from time to time will have a direct effect upon the fortunes of the particular unit with which they are concerned.

The problems of management are many sided and the responsibilities are great. "What, therefore, are the means by which management can hope to discharge its task successfully?" The answer is—"By scientific organization and methods and by utilizing all the assistance that science can render."

The system of organization of a large industrial unit is of necessity complex. It is a most delicate and sensitive instrument and the basis is a complete and scientific accounting system. By this I do not mean

merely the ordinary system of double-entry book-keeping but the whole system of records and statistics.

Management may be likened to the eyes and the brain, and the accounting system to the nerves, in the human body. What the eye sees is [illegible] conveyed to the brain which, in its turn, operates th[illegible]s of the nerves. Again, immediately any part of the body is affected by any outside influence, through the nerves the brain is made aware of the fact. Exactly in this way must the accounting system operate in the industrial body and as in the case of the human body, if the nervous system fails to operate, the whole body is affected, so in the business organization, if the accounting system is defective paralysis sets in. The brain no longer controls the body, with the result that health departs.

The setting up of the system in the case of a large industrial concern is a highly technical matter requiring great skill and care. The organization must be such that although the individual transactions may run into countless numbers, yet the whole position is clearly focused and no change can take place without management being immediately made aware of it. There are in every business a number of control points which must be watched and it must be by means of the accounting system that this is effected.

Management is concerned with watching trends and tendencies, making comparisons, seeing what things are and what they should be. If the system is complete and efficient, management will be enabled to watch the whole working of the organization and thus become immediately aware of any defects and adverse factors. Only in this way can maximum efficiency be attained and all avoidable waste eliminated.

The fault with the majority of systems is that the view point is in the wrong direction—that is, backwards instead of forwards. Of necessity, the accounts record past transactions and the annual accounts reveal merely the results of completed operations.

From the point of view of management what is required is not so much to know what happened six months ago, but what is likely to occur six months ahead. The problem to-day is, therefore, how to use the records of the past as a guide to the future and how to organize the system so that it may meet the needs of management in the day-to-day control of affairs and provide the material upon which to base the future policy and plans. The accountant commonly concerns himself solely with the records of the past and has a natural disinclination towards having anything to do with forecasts. If the accountant refuses to depart from this conception of his responsibilities, in my opinion he is failing completely to realize the enormous possibilities which lie before him of rendering invaluable service to industry. From management's point of view a careful forecast of what next year's balance sheet is likely to be is of far greater practical value than the balance

sheet of the past. Management is concerned with the future—the past results are of value in so far as they are a guide to the future.

Every-day decisions which management has to make are as follows—

What is our production programme to be for the next six months?

Which lines shall we manufacture and in what quantities?

What will our requirements of raw materials be and in what quantities and when shall we purchase?

What are the prices likely to be?

What stocks should we hold of each class of stores, raw materials and finished goods?

What plant capacity shall we need to carry out our production programme?

What will be our labour requirements?

In order to meet our production programme, what will be our requirements of special tools, drawings, inspection gauges, packages, storage capacity, transportation facilities, power, etc.?

What are our costs of production likely to be?

What are our factory and general overhead charges likely to be?

What are the marketing possibilities?

What is the turnover of the individual lines likely to be?

What will it cost us to sell and distribute our production?

What will our financial requirements be in order to carry through our production and marketing programme?

Where do we stand in the trade cycle?

What is the present ecomonic position and what is the probable future trend of our industry?

What is the ecomonic position of our various markets likely to be?

What is our general policy to be?

The foregoing are some of the many decisions which management has to make and the fortunes of the whole concern and all parties interested in it must be directly affected thereby. These are the vital responsibilities of management and the decisions should be based upon a reasoned examination of all available data and in this direction the accountant and the economist can render invaluable service. There can be no more dangerous policy than to base these decisions upon blind guesswork, as is so often the case in practice, for such methods are equivalent to navigating a ship by guesswork and casting overboard the charts, compass and weather gauge. To trust to luck is the counsel of the foolish, but there are many businesses in this country to-day managed upon this basis.

It is impossible in the time available to do more than indicate the general direction in which the accounting organization of a business may render real and practical aid to management.

A most practical service is by the organization of a system of budgetary control. This idea is not a new one, our government finances having been based upon a budget for generations past, but industrial

enterprises in this country have only recenly commenced to apply this system, which, however, is widely used in America.

The basis of the system is that management must plan ahead for the coming year and that every section of the concern must work to this plan, so that in this way a true balance may be attained throughout the whole organization.

The whole plan is based upon the forecasted sales volume for the coming year; the production, buying, stock, expenses and financial requirements of this programme are calculated in detail. Each department and section then works to the budget and actual performance is compared with the budget forecast. In this way each section is given a definite standard to aim at and each is working in time with the others.

The foundation is the sales forecast which is based upon a market analysis and past sales performance. The object is to measure the market and ascertain the sales possibilities; that is, "what ought we to sell in each area?" The salesman in one area may have been most efficient and have expanded his turnover to the maximum whilst in another area the salesman may have exploited only 50 per cent of the possibilities. But how is management to ascertain that this is the position?

The measurement of the market possibilities of each sales area requires careful research work, and the base factors depend upon the nature of the articles to be marketed. For example, population is a factor in the case of articles of common use such as matches, but it would not be a realiable factor in determining the market possibilities for the sale of Rolls Royce cars, as the number of individuals having the necessary purchasing power to buy expensive cars is strictly limited. If the concern were selling agricultural machinery, an obvious factor would be the number of farms in each area. In some cases climate is a factor, for there would be little prospect of marketing skates in Central Africa!

The problem is to ascertain the purchasing power of each sales area and it is a matter of careful research to fix the various factors. The following are a few examples—

Past sales performance.
Population.
Number of distributors.
Local conditions.
Local competition.
Number of users.
Rateable value.
Purchasing power of consumers.
Climatic conditions.
Unemployment.
Distribution facilities.

In order to prepare the budget, each salesman is required to submit a forecast of his sales of each line for the coming year. These returns are scrutinized in the light of the market analysis and may be increased or reduced, consideration also being given to the forecast of the general economic conditions. When finally fixed by management, each salesman is advised as to his quota. In this way there is a great incentive, as the salesmen have a definite goal at which to aim and they know that their efficiency will be judged by the comparison of actual performance against the quota, which latter was largely based upon their own forecast. This system forces salesmen to think ahead and enables management to judge results. It also leads to balanced selling, as there is a natural tendency for salesmen to push lines which are easy to sell and neglect those which are difficult, the result of which must be disorganization of the production and stock programmes. Under the budget, the quota gives the quantity of each line to be sold and actual performance is compared and in this way the importance of covering the whole range of lines is made clear to each salesman.

The master sales budget shows the quantities for each line of goods, and it is then broken down by the production department into the quantities of the various classes of raw materials and labour required, the plant capacity, tools, gauges, etc., and from this a detailed production programme is drawn up.

If further plant capacity is required, the engineering department will proceed accordingly. In the same way the buying department will proceed according to the budget and stock levels will be fixed and based on the general plan. The personnel section must see that the requisite type and quantity of labour is available. In fact, the whole programme is split up into every detail and steps are taken to ensure that everything necessary is provided for.

The finance department must calculate the exact financial requirements and arrange accordingly. The whole of the works, administrative, financial and selling charges must be forecasted and included in the master budget, which in fact represents a forecasted Manufacturing, Trading and Profit and Loss Account for the coming year.

Each spending department is advised as to its agreed expense budget, in the setting of which it will have taken part, and no expenditure in excess is allowed unless specially authorized by management.

The whole undertaking thus proceeds upon a definite plan, balanced throughout and based upon forecasted sales volume. Obviously, however, it is impossible to ensure that actual sales and expenses will coincide exactly with the forecast; many contingencies will arise from time to time which will upset the most careful calculations, such as labour troubles, changes in demand, variations in the general economic conditions, fluctuations in price levels, transportation difficulties, plant breakdown, failure of supplies, etc. Upon the happening of any such events, the plan must be varied accordingly by management and

each section must change time accordingly. The position is similar to that of a commander-in-chief in war who mounts an offensive, which must be based upon a carefully drawn up plan in which every detail has been considered and provided for. But the operation will rarely develop exactly according to plan and therefore the organization must be elastic, so that variations can be made to meet the unforeseen contingencies as they arise. But as in war, so in industry, a detailed plan there must be if success is to be attained.

Having fixed the budget as the year proceeds, the accounts departments should prepare statements whereby the actual performance of each salesman and the working of every section of the whole concern is compared with the budget figures. In this way management has complete control over the whole organization and can see at a glance whether balance is or is not being attained. If general results do not coincide with the budget, it can be seen where the failures have occurred and in which sections.

The ideas underlying the budget plan are very simple—i.e. that you study past performance, consider what you should do in the future, draw up a detailed plan, set up an organization to carry that plan into effect and subsequently compare actual performance with your estimates.

There are many successful businesses which do not work to a budget, but they must go through this process, for there must be a plan and an organization for carrying it out. They arrive at the same results but in a different manner.

The advantages of the formal budget are that it forces the executive in every section to think and plan for the future and in this way standards of efficiency are fixed by which results may be judged. To be successful the whole personnel must be educated up to the idea, as it will never be successful unless it has the enthusiastic support of all. From the top management downwards, the advantages to be gained from this type of organization must be fully appreciated.

The various sections are largely responsible for fixing their own standards; they must therefore think ahead and there is a stimulus to endeavour to reach the goal. On the expenditure side, this plan should effect considerable economies, as instead of expenses accumulating during a year without control, the expenses have to be forecasted and special authority obtained for any excess expenditure, and thus a very effective control is obtained.

I do not wish you to think that I suggest the budget will cure all the ills of a business or that it is necessarily suitable to every class of business. The budget cannot replace management, but it should be of great assistance to management in the control of a business concern and it should increase efficiency.

My reason for discussing this system is that I consider that the accountant can render far greater assistance to industry than he has

done in the past if he will co-operate with management in planning ahead. The responsibilities of management are very heavy and the fortunes of all interested in the concern are directly dependent upon the decisions which have to be made. Management's principal function is to look and plan ahead and therefore the accountant must be looking in the same direction, if he is to render real aid.

Chapter XIII

The Role of Finance and Accounting in the Management of Large Business Combines

A paper delivered before the British Association for the Advancement of Science on 5th September, 1933.

TOWARDS the latter part of the nineteenth century there commenced a noticeable trend towards the formation of large business undertakings, and this movement has been more or less continuous ever since. During this same period there also developed a marked tendency towards combination in industry and trade.

In recent years this movement towards combination has commonly been called "rationalization"—a term very difficult to define but which recently was on everyone's tongue—but to-day this word, and the movement that it represents, is in some disfavour and there are many who lay part of the blame for the bad times through which we are all passing at the doors of "rationalization."

I would suggest that this is due to several factors. In recent years many of the large combines have shown heavy reductions in earnings; in some cases considerable losses have been incurred, and there have been several spectacular failures. But a storm at sea falls indiscriminately upon all vessels, large and small, and the economic tempest that has raged throughout the world in recent years has affected all businesses, including the large ones—none could escape.

Undoubtedly the unprecedented depression has found out the weak points in industrial organization. Industry has not had a long experience in the creation, direction and control of vast undertakings just as at the outbreak of the Great War, this country lacked experience in the organization, direction and control of an army upon the scale that then became necessary. Some of the modern combines were ill-founded, badly organized and mismanaged. In such circumstances it was not surprising, in fact it was inevitable, that the acute and long-drawn-out depression should cause disaster.

On the other hand, it is possible to point to many sound and well-managed combines that have weathered the storm remarkably well and these cases illustrate the value, in bad times, of the massed strength of the large combine, when efficiently organized, and managed.

The large industrial combine, by reason of the vast scale of its operations, has certain definite advantages, but on the other hand there are important difficulties and dangers. A vital problem is the setting

up of a complete and sound organization adapted to meet every need of the concern, and the provision of the right personnel under wise leadership.

In the case of a small business undertaking it is possible for the proprietor to supervise and control practically the whole of the activities of the concern. But in the case of the large business combine this is impossible. Owing to the vast scale and ramifications of the operations of such a business it is absolutely impossible for the higher management personally to supervise and control every activity, as the point of action is often far removed from the seat of management.

The immediate problem, therefore, that arises is one purely of organization, and upon this success or failure will depend. Without a sound system of organization it is impossible successfully to direct and control such an undertaking.

The great difficulty is to find the men with the knowledge and experience successfully to undertake these great responsibilities. This is not surprising in view of the fact that very little has been done in this country to train men specially for this work. But even with the right men, the organizing of a large combine is a most complicated and difficult task and one requiring great experience, skill, tact, and patience. Furthermore, owing to a general lack of experience in this particular problem, the methods employed must of necessity be largely empirical. We are crossing an ocean that has been only partially charted; it is not surprising, therefore, that there have been many shipwrecks.

Combination may be effected in various ways, but for the purpose of our considerations to-day I am imagining a holding company which is itself an operating company and which controls a number of subsidiary companies, both at home and abroad, some of these subsidiary companies being manufacturing ones and others selling companies.

In setting up the organization of any business, consideration obviously must be given to the placing of finance (including accountancy) within the general scheme of organization of the concern.

The activities of every manufacturing business comprise four main functions, i.e. manufacturing, marketing—commonly divided between home and export—purchasing, and finance, and these represent the main divisions of the organization of the modern industrial undertaking. Each of these main divisions of course may be subdivided into many subsidiary functions. Likewise in some concerns, purchasing is placed under manufacturing.

In the best organized companies these management functions are of equal importance. This, however, is not the basis upon which most businesses were organized in this country in the past and upon which many are organized to-day.

Finance is the basis of industrial enterprise and, therefore, it is of the utmost importance that the financial control of the whole organization shall be as efficient and effective as possible. In order to attain

this it is essential that the finance division shall be staffed by men of attainments, character and personality, fitted to be the equals of the other chief executives, and that they should be given that position in the organization as a *sine qua non*.

Success will not be achieved merely by a well-drawn organization chart, but only by the selection of the right individuals to fill all of the various posts throughout the organization, for the all-important thing is "the man behind the gun."

It was, and is, commonly found that manufacturing and marketing (*a*) Home and (*b*) Export, are major divisions, the executives in charge of each having an equal status and being the three senior executives immediately below the managing director. In this type of organization finance and accounting are represented by an executive commonly called the chief accountant, who, however, is not of equal status with the heads of the other divisions.

Experience has shown that there are serious weaknesses in this type of organization. For example, it is commonly found that a scheme put forward by the head of the manufacturing or marketing division to the managing director is, after consideration and approval by him, immediately submitted to the board of directors. Subsequently the chief accountant may have to report the adverse effects that that policy has had upon the financial position of the concern. In such circumstances the functions of the chief accountant are mainly historical, which is not helpful to management in the direction and control of the business.

It is obviously vital that every aspect of any scheme or policy shall have been considered thoroughly before action is taken, but it is too commonly found that the financial defects are realized only after the scheme or policy has been carried into effect and when the damage has been done. It is therefore most desirable that whenever the board is considering any proposition, the financial considerations involved shall be submitted clearly to the board, together with the commercial and technical aspects.

Upon this principle I now wish to consider the type of organization most suitable for a large business combine and to describe briefly the main functions and responsibilities of the Finance Division.

At the head of the organization is the board of directors responsible for the main policy and ultimate control of the whole undertaking. The board determines the aims of the business, the methods by means of which these aims shall be achieved, and periodically checks progress.

The board having determined the policy, the managing director has the responsibility of putting the plan into execution and of co-ordinating the whole of the activities involved, e.g. (*a*) manufacturing, (*b*) buying, (*c*) selling and distribution, and (*d*) finance.

The four chief executives under the managing director would be the heads of the four main divisions whose titles, I suggest, might be Controller of Manufacture, Controller of Purchasing, Controller of

Sales, and Controller of Finance. The managing director, together with these four executives, would, in effect, form a board of management for the whole combine and would consider in detail every plan before submission to the board. If approved by the board, these executives would be responsible for putting every detail of the plan into execution and for seeing that the plan is properly carried out.

The constitution of the board of directors is a matter of great importance and practice differs widely. On the one hand, it is common to find boards composed entirely of individuals who take no part in the actual conduct of the business, and on the other, boards composed entirely of the principal executives of the undertaking.

In the case of a large combine I would suggest that the ideal board of the main company is one composed of the principal executives together with an equal number of outside directors who should be men with a wide experience in business. In this way every aspect of all propositions laid before the board would be effectively voiced and the outside directors would bring to the board's deliberations wide experience together with sound and unbiased judgment.

Upon the principle that the "onlooker generally sees most of the game," the judgment of the outside members of the board will often be better than that of the executives who are involved in all the details of the operations of the concern. On the other hand, the presence of the chief executives should ensure that every factor, including the financial considerations involved, is fully considered before the final decision is made.

Under an organization such as I have described it will be seen that the controller of finance would be taking a direct part in the management and control of the whole combine. The function he represents is interlinked with those of the other main divisions and in my experience all the divisions gain greatly by this direct contact. In this way, instead of each division being a separate water-tight compartment, they work together, learn to understand each other's problems and pull together as a team. In no other way can complete success be achieved.

Working upon these lines the finance division is able to render valuable service to the board, the managing director, and the controllers of manufacture, sales and purchasing, to an extent that is quite impossible under the old type of organization.

It is essential that the finance division, from the top to the bottom, shall gain the confidence of the other divisions by understanding and helping them in their problems. Of necessity the function of the finance division is largely critical and very commonly the whole department is most unpopular, being regarded as a spy and mischief-maker. This is a very real difficulty and it can only be overcome by tact and consideration and by imbuing the whole finance department with a true team spirit. The aim of the department should be to "Sell a service" to the other departments of the organization, and if it is run upon these

lines from top to bottom, it is remarkable how quickly all divisions begin to appreciate the services of the finance division and how much the organization as a whole benefits through the co-operation of the various divisions in this way.

In considering the organization of the finance division as a whole, the problem would immediately arise as to the extent to which finance and accounting should be centralized. The same problem arises in connection with the organization of the other divisions. Over-centralization has been, I suggest, a common and serious weakness in many large combines, and the general principle, in my opinion, should be the centralization of control and the decentralization of responsibility.

As regards the finance division, obviously it would be foolish to dogmatize upon this point. There are combinations in which a high degree of centralization has given very satisfactory results, but in the type of organization that I have visualized, a policy of decentralization with helpful central control is, according to my experience, far more likely to give satisfactory results.

The finance division at head office would be headed by the controller of finance and each unit in the combine would have its own finance and accounts department under a local accountant. The organization of each unit would be upon the same lines as I have indicated for the head office of the combine, i.e. it would be divided into main divisions, one of which would be finance and accounting.

In the same way as at the head office, the local accountant should co-operate with the heads of the other divisions of his unit and should render to the managing director or general manager of that unit exactly the same services as the controller of finance would render to the managing director of the main company.

The status and responsibilities of the chief accountants of the units in a combine should be upon the same lines as those of the head of the finance division of the main company. In practice, however, it is commonly found that the local accountant has merely the status of a head book-keeper; he plays no part in the management of the unit and thus his function is mainly historical.

In every unit in the combine the financial voice should be a strong one and the local accountant should have an important contribution to make towards the efficient management of his unit. He should render invaluable service to the managing director or general manager of his unit, and, further, the effectiveness of the financial control of the whole combine directly depends upon the effectiveness of the work of the local accountants; upon them the controller of finance must depend. It is therefore of the greatest importance that the right type of man shall be selected for these posts and that he should be thoroughly trained for these responsibilities.

The accountant of a unit would be responsible, under his general manager, for the whole of the finance and accounting functions of

his unit, but the controller of finance would lay down generally the methods to be adopted.

As I have already said, the success of the finance division must depend upon the executive work of the chief accountants of the various units, and the functions of the controller of finance are to act as the leader of the division. But success will not be achieved by issuing orders from headquarters to the local accountants, in fact that method of approach may have the exactly opposite effect.

The local accountant reports to the general manager of his unit, and the general manager reports to the head of his group or division. Therefore nothing but harm will result from the controller of finance cutting across the lines of the organization and issuing orders to the local accountants. The controller, therefore, must always contact direct with the heads of divisions. This, however, does not mean that he should have no direct contact with the local accountants. In my experience the controller's most effective work will result from the keeping up of a personal contact with the local accountants.

In order to do this, the controller should personally visit periodically as many units as possible and he should make a point of seeing accountants home on leave from foreign units. In this way he is enabled to get to know the men, to stimulate their thoughts, to give them a picture of his main policies and plans, to discuss their difficulties and generally to inspire them with *esprit de corps*. All of this he can do by means of periodical tours without in any way interfering with the lines of control. If the controller himself has the right personality, the results of these contacts will be surprising and prove to be far more effective than official instructions issued from headquarters.

The appointment of the controller of finance would be a board appointment and he would report direct to the managing director. Thus he would be in an independent position and enabled to act as the financial adviser to the combine.

As regards the chief accountants of subsidiary companies, although they each report to the managing director or general manager of their respective units, yet circumstances may arise, such as suspected fraud, when it may become necessary for them to report direct to the controller of finance. They should therefore be given that right, although it should be exercised only in very exceptional circumstances. In the first case the local accountant should invariably report to the managing director or general manager of his unit any matters as to which he is not satisfied, and he might recommend that the facts should be reported to head office. If the general manager refused to do this, if the accountant considered the matter to be of vital importance, he should, with the knowledge of his general manger, report the facts to the controller of finance.

In the ordinary course the controller's direct contact with the affairs of a unit is, as I will explain later, by means of his internal audit staff.

Having attempted to describe in very broad outline the finance division and its place in the organization of a large combine, I now propose briefly to describe some of the main responsibilities of this division.

Under the type of organization that I have outlined, the controller of finance would be, as I have described, on a level with the heads of the other main divisions and he would be a member of the board of the main company, or if not a member he would attend board meetings in order to represent finance. He would therefore take a direct part in the management of the whole combine. He would be in direct touch with the managing director and with the main policy of the board and he would also be in close contact with the heads of the other divisions and thus be familiar with their main problems and difficulties.

The working of the division as a whole may be divided between the following responsibilities—

(*a*) Finance.
(*b*) Accounting.
(*c*) Measurement.
(*d*) Forecasting.

FINANCE

This would embrace the provision of the necessary capital of the combine, the investment of surplus funds and the general financial policies. These matters would, of course, be decided by the board, but it would be the responsibility of the controller of finance to bring before the board all the necessary data.

The total capital requirements of a large combine will amount to a considerable sum and will be provided in various ways, e.g. share capital of various classes, long term debentures and mortgages, short-term loans, bills of exchange and trade credits, etc. The total capital required varies considerably from time to time owing to the volume of sales, the level of prices and other factors. The decision, therefore, as to the proportions to be raised under each head is a matter of great importance.

The controller of finance would be responsible for seeing that the available capital is equitably apportioned between the various units, that rigid economy is exercised in the use of capital throughout the organization, and that the financial policies decided by the board are carried out. He would also be responsible for examining and reporting upon the financial aspects of all schemes submitted to the board.

In general, he would be responsible for the control of the financial structure throughout the whole organization.

ACCOUNTING

This represents the recording of all transactions and would involve the setting up of an accounting, costing and statistical organization for the whole combine and include the preparation of the final accounts

for the year and the periodical accounts, returns, and progress reports during the year.

With a view to comparisons and consolidations, etc., it is obviously most important that the accounts, costs, statistics and budgets of all units in the combine should be prepared upon exactly comparable bases. It would therefore be the responsibility of the controller of finance to lay down in detail the standard bases upon which these various records should be prepared and what accounts, reports and returns shall be submitted to head office and the dates when they will be required. The controller of finance should also be generally responsible for seeing that up-to-date and efficient accounting methods are adopted throughout the organization.

In view of the fact that the units of a combine such as we are considering would be spread all over the world and that in many countries abroad native staffs would be largely employed, considerable advantages are to be derived from the preparation of a manual of standard practice. In the manual exact details should be given as to how every class of transaction is to be handled, how all items are to be classified, the exact form in which and the dates when all accounts, returns and reports are to be prepared and submitted to head office, the basis upon which assets are to be valued, and all the other information necessary in order to ensure that the accounts, costs, statistics and budgets of all units are prepared upon an exactly comparable basis. If this is not done it will be found that the various local accountants will all have different ideas and handle matters in different ways so that it will be impossible to arrive at comparable results.

In recent years increasing attention has been directed towards the mechanization of accounting and the introduction of labour-saving methods, with a view to speeding up the work and reducing its cost. In my opinion there are great possibilities of further developments upon these lines.

The whole system must be designed so that all the essential factors are clearly focused and this information must be available promptly to be of any value to management for control purposes.

In the old days management was contented with accounts prepared once a year, but to-day means must be provided by which the whole position can be watched constantly throughout the year. Monthly accounts, together with numerous returns, are required and the accounting and costing systems must therefore be organized accordingly.

The work and expense involved in accounting is considerable and therefore great waste will result if accounts, reports and statistics are compiled that do not serve a practical purpose. In course of time this situation will inevitably arise and, therefore, the whole organization should be overhauled periodically with a view to eliminating every unnecessary return, etc., and also to ensure that the whole of the work is carried out in as simple and efficient a manner as possible.

In connection with the accounting system it is most important that the classification of the figures shall throughout the organization follow the lines of the organization structure; in other words, that the classification shall be by responsibilities. If a single classification embraces two or more responsibilities, the figures are valueless for control purposes. For example, all the expenditure directly controlled by each particular department should be separately classified, so that the responsibility for the result is clearly fixed, otherwise the manager of the department will always have an alibi.

The form of presentation of figure statements is a matter of importance and many statements are spoilt by the inclusion of unimportant detail which makes the statement difficult to read, so that one cannot "see the wood for the trees." Everything should be done to make all figure statements crisp and clear and thus easy to read and understand. In this connection graphs are of great value, as not only are they much easier to read than a figure statement, but often a graph will reveal a trend which has not been observed from a study of the corresponding statement of figures.

In the case of the financial accounts of business undertakings, there is room for considerable improvement in the way the figures are presented. Under the old-fashioned methods still commonly practised in this country, a single column of figures is shown on each side of the accounts. This form of presentation is particularly uninformative and makes the accounts difficult to read; whereas if the items on both sides of the accounts are grouped and sub-totals shown it is remarkable how this very simple innovation clears the picture.

If a Balance Sheet is grouped in this way with sub-totals, the main features of the financial position can be seen at a glance and in particular the ratio of current assets to current liabilities, which is one of the key points of the financial position, is clearly shown. Further, the reading of the Balance Sheet is greatly facilitated by the inclusion of the figures for the preceding year.

I am sure that all of this must appear most obvious to all of you, but it is only too common to find that these simple principles are not complied with and, in consequence, the management of the concern does not obtain the full benefit from the accounts and records for the purposes of direction and control.

Internal Audit Department

However carefully we may build up our organization, human weakness will at times upset our plans and serious errors and even fraud may creep in. For this and other reasons an internal audit department is a most important part of the accounting organization of a large combine.

The internal audit department must report direct to the controller of finance, as the internal auditors must be in an independent position in order to carry out their responsibilities effectively.

This function is of great importance and if properly operated the internal audit department should render valuable service to both the local management and to headquarters. But success will depend upon the selection of the right type of personnel. They should be trained accountants with a commercial sense and a knowledge of the particular business, and they should be young men of tact and good personality. In the course of their work they should make every effort to gain the confidence of the executives and create the impression that they are there to help and not to act as spies and trouble-makers. Their criticisms should therefore be constructive and helpful.

The internal audit department enables headquarters to maintain a direct touch with the various units, and in this way fulfils a very useful purpose.

Measurement

In a large combine, the mass of detailed information contained in its books of account is prodigious, as every single movement is recorded. But for control purposes the records are of little value to management unless the essential factors are clearly focused and there are means by which they can be measured.

To know what an article has cost is information, but what management requires to know at the same time is what the article should have cost. Therefore actual costs are measured against standard costs and operating results against budget forecasts, etc.

In the ancient and learned professions it is possible, as the result of scientific investigation and the careful measurement of collected facts, to predict results with a high degree of accuracy. For example, engineers when designing a great bridge, calculate the strains and stresses and all of the requirements with extraordinary accuracy.

In the management field it is now being realized that exactly those same methods can and should be applied with the same end in view.

In the records of a business there are stored all the necessary data and all that is required is for these to be carefully analysed, measured and studied. I feel certain that we do not yet realize fully the great advance that will have to be made if a scientific study upon these lines is to be fully developed. At the present time we are but slowly finding our way.

In a large combine this task is a considerable one, as every part of its operations requires to be studied minutely with a view to establishing standards of measurement or "yard sticks." This study will be of the greatest value to management, as in all figure statements results can be accurately measured by means of these "yard sticks."

To be effective this study must be carried out by the finance division in co-operation with the technical experts of the other divisions, in fact a great part of this work involves technical matters which must be undertaken by engineers. For example, time and motion study, which

plays an invaluable part in the operation of a modern factory, is a highly technical matter and necessitates specially trained staff. The fullest co-operation throughout the whole organization is necessary if success is to be attained.

One of the most important functions of the finance division is the reading of the records for the benefit of management. Results, therefore, should be focused clearly and crisply, compared with the standards of measurement or "yard sticks," in a form that "he who runs may read." At head office this work will be performed by the controller of finance and at the units by the local accountants.

Forecasting

A common and serious weakness in the organization of many businesses is that their accountants are constantly looking backwards instead of forwards, which is not very helpful to management.

Only a madman would go to sea without working out the course ahead, and it is just as essential in the case of a business to do exactly that same thing. But there are comparatively few businesses in this country that have organized a complete budgetary system.

In the case of a large international combine such as we are visualizing, effective control is impossible without some form of forward planning. A forward view is obviously essential for the board and managing director of the main company, but it is equally necessary for the managing director or general manager of every unit in the combine and also for the chief executives of each department of a unit. Success must depend upon forward planning, and a system of budgetary control is merely a system which enables plans for the future to be worked out in every detail.

By means of a budgetary system the finance division is enabled to see not only what last year's accounts revealed but what next year's position is likely to be—the former is history and cannot be altered, but management can control the future to a material extent, and if the trends shown by the budget forecasts are adverse, action can be taken immediately with a view to improving the position.

The budgetary system should be interlinked with and form part of the accounting system and the system of managerial control.

Every unit in the combine should be responsible for the preparation of its budgets for the coming year, and these budgets should be revised periodically, say quarterly. The budget should be divided into three sections—

(*a*) Profit and loss budget;
(*b*) Capital expenditure budget;
(*c*) Finance or cash budget.

The budgets of the various units should be combined by the controller of finance into a master budget, which also would be divided into the three sections that I have described.

The profit and loss budget of each unit should be prepared in exactly the same detail as the Profit and Loss Account itself. This budget is, of course, founded upon the sales forecast prepared by the sales departments.

In the capital expenditure budget particulars should be given of the estimated capital expenditure for the coming year.

The finance budget, which is based upon the profit and loss and capital expenditure budgets, shows month by month for the coming year the estimated cash position of the company.

These budgets should forecast clearly the future course of each unit and of the combine as a whole, both as regards the operating results and the financial position, thus directing the attention of management towards all the weak points.

A budgetary system in my experience greatly strengthens managerial and financial control and results in economy in both revenue and capital expenditure. It forces all executives to plan and think ahead and greatly facilitates the control and co-ordination of the whole of the activities of the combine which are by these means intelligently directed according to a carefully considered plan.

The budget forecasts provide the means by which it is possible to measure periodically the limit of deviation which actualities and realizations bear to the normal or ideal, and by forecasting trends they enable action to be taken before the event. This work may be likened to that of the navigation officer of a ship when he calculates the course ahead and constantly checks the position of his ship.

One of the great practical difficulties is the provision of the right type of personnel for the whole of this work. For the "finance" and "accounting" part, trained accountants are available, but the difficulty arises in connection with "measurement" and "forecasting." Little has been done in this country to train men for these aspects of the problem. The professional accountant's training is, it appears to me, directed almost solely towards the production of practitioners and not accountants for industry itself, and I am convinced that the accountancy profession should seriously consider the desirability of broadening the training of their students to embrace these most important subjects.

For this work it is essential to have the "scientific mind," backed by technical accountancy, together with a vivid imagination and commercial sense. To-day it is very difficult indeed to find men possessed of all these qualifications, and one of the problems of industry is the training of men for these responsibilities. I suggest that industry, the accountancy profession, and the universities have each a contribution to make towards the solution of this important problem, and that they should give it serious consideration.

The subject that we have been considering is a very complicated one and in the time available it is not possible to do more than sketch

the picture in broad outline. Even so, I am afraid that my picture is very blurred, but it may serve to create discussion.

The great importance of a sound financial organization cannot be over-emphasized, for financial weakness affects the minds and policy of management. If the ship is making water fast and heading for a dangerous shore, it is extremely difficult for the officers to keep cool heads and their efforts will be wholly directed towards overcoming the immediate dangers at whatever cost, even though this entails jettisoning valuable cargo. Exactly the same is the position in the case of a business undertaking that is drifting into financial difficulties.

Furthermore, if the financial position is weak, then in times of adversity that undertaking's power of resistance and its recuperative capacity must be low.

In the case of a large combine, the maintenance of a healthy financial position throughout the whole organization during a long period of adversity is the severest test, and is only possible if the financial control throughout is sound and efficient. An international combine such as we have visualized is so vast and widespread, it has so many ramifications, is affected by so many different influences, that it is particularly susceptible to financial diseases which may develop into creeping paralysis. The subject, therefore, that we have been considering is of supreme importance in industry to-day and it is greatly exercising the minds of all who have the heavy responsibility of directing and controlling large combines.

Chapter XIV

The Principles and Practice of Budgeting in Modern Business

A paper delivered before the South Wales and Monmouthshire Chartered Accountant Students' Society on 24th January, 1936, and to the Chartered Accountant Students' Society of London on 19th February, 1936.

THE Chairman (The Right Hon. Lord Plender, G.B.E., LL.D.), in introducing the lecturer, said: By the courtesy of Mr. de Paula, I have had an opportunity of reading his paper before coming to this meeting. It is in my opinion a most valuable contribution to the science of management in industry in its many aspects. Control of expenditure merely in its composition for each process of manufacture without being related to a sales policy is of little real value. The two must be considered not as separate parts of a problem, but as the problem itself.

To ascertain production costs under a well devised costing system is now fairly well understood; but the further costs in disposing of the articles produced before reaching the customer are of equal importance, as on them and their correct estimation largely depends the contribution to profits or losses. This aspect of the question is difficult to determine in advance, as Mr. de Paula illustrates, and any method which claims infallibility would be foolish. But there are directions in which experience has taught us to look for guidance, and Mr. de Paula's practical knowledge of the subject of which he gives us the benefit in his paper, should be a stimulant to study and research.

I doubt if sufficient attention has yet been given by industrialists and manufacturers to the related outlays of distribution to production quantity and costs, or volume and value of sales or other basis of comparison, and bases may vary in different businesses.

Mr. de Paula's paper covers much ground and is a striking example of scientific inquiry applied to a very important subject in which we should be concerned. And whilst practising accountants are often instructed to put in a system of works costing, their principals do not, generally speaking, associate them with the classification of costs of distribution and administrative expenses. These outlays which the management is responsible for are rising, for example, through the growth in press advertising, posters, travellers' salaries, etc., and the question is, are they justified in the results obtained?

Mr. de Paula: I feel that I owe you an explanation for having chosen this subject for discussion to-night, as many of you may feel that it is far removed from the sphere of the practising accountant.

I am, however, strongly of opinion that our profession should keep in touch with, and study the problems of, management for the following reasons—

The practising accountant is commonly referred to as the business doctor, in which capacity he is called upon to diagnose the complaint when the patient is sick and then to advise the remedy. In the case of the industrial patient the cause of the sickness, only too commonly, is due to faulty management and an ineffective system of control.

The medical profession studies exhaustively every aspect of the human body, its complaints and weaknesses and their cure, and I suggest that it is just as important that our profession should study every part of the industrial body, its complaints and weaknesses and their cure.

In these days the professional accountant is commonly called upon to investigate a business that is in difficulties with a view to advising how, if at all, its position of affairs can be mended.

In order to carry out such an investigation successfully, a wide knowledge of management is invaluable. The great difficulty, however, is for the practitioner to gain experience in the sphere of practical management, apart from finance, as to which his training makes him an expert. In the case of an ailing business, more often than not the root of the trouble is to be found in the sphere of management, the effects of which are merely reflected in the financial difficulties.

As liquidators and receivers, accountants often have to carry on business and therefore in this capacity a knowledge of management is of the utmost value.

There is another aspect of the question which I feel our profession is apt to overlook, namely that a considerable proportion of our members is engaged in industry itself and I think that this tendency will increase in the future.

To-day, Chartered Accountants are to be found on the staff of almost every large company and many of them in positions of considerable responsibility.

For these various reasons, my personal opinion is, that you students will be well advised to take advantage of every opportunity to study the problems of scientific management.

In the first place I think it is necessary to come to a clear understanding as to what we mean by budgeting, or the term which is most commonly used, namely "Budgetary Control," which is not altogether a happy one, but it has become generally accepted.

This term was first used by the British Chancellor of the Exchequer in the 18th century. This first budget was a somewhat crude affair, but it showed the expenditure for the preceding year, estimates for the coming year and outlined a method of taxation in order to raise the total required. Many other Governments and municipalities have since followed this same practice.

In recent years industry has discovered that this same system is most helpful for the purposes of control. This practice has been widely adopted in the United States of America and is now making rapid progress in this country also.

At an International Conference on Budgetary Control held at Geneva in July, 1930, the following definition, which I think is an excellent one, was given—

"Budgeting is not merely control; it is not merely forecasting; it is an exact and rigorous analysis of the past and the probable and desired future experience with a view to *substituting considered intentions for opportunism in Management.*"

It always seems to me that budgeting in business is exactly like the navigation of a ship. Only a madman would go to sea without working out his course ahead. Before putting to sea the wise captain works out his course and frequently checks the ship's position compared with the predetermined one. Furthermore, if the ship is in shallow water, soundings are constantly taken. This it seems to me exactly describes the functions of budgeting in business which represents merely planning for the future.

All organized businesses must, and do, plan ahead in some form or another, and the most successful business in the long run will always be the one that is most accurate in its forecasts, is most frequently checking its position and that is planning furtherest ahead.

By installing a budgeting system we are merely setting up machinery by means of which every detail of our plan and every known factor affecting it must come under review and be provided for in our calculations. Only in this way can we be certain that no factors are overlooked and that our calculations are as accurate as is possible. By setting up such a system we learn by our mistakes, thus gaining experience and attaining increased control over our affairs.

Planning ahead, therefore, is the basis of organized business and upon which success directly depends, and there is no doubt that faulty planning ahead has piled many an industrial ship upon the rocks. Careful planning is necessary from the birth of the business, right through its life and in every section of its organization, and in the case of a large international combine, this is a complicated and vital problem.

The problem we have to consider to-night is the exact place of budgeting in the organization of a modern business, and what are its objects and advantages.

The views I shall express are based upon practical experience. The first use of budgets in our company was in the case of one of our overseas companies where such a system was installed some thirty-five years ago. Some five years ago we organized a complete system throughout the company's whole organization all over the world. We could not have started this system at a more difficult time and it has therefore been proved out under the most testing conditions.

Several other important companies in this country have also adopted budgetary control, and we have exchanged experiences.

This summer Mr. R. Dunkerley delivered a paper on Budgetary Control before the International Congress for Scientific Management and two appendices attached to the paper comprise questionnaires answered by a number of companies in this country recording their experience and conclusions. There is thus recorded the practical experience of a number of companies in this country, and those of you who are interested, I strongly recommend to study this paper.

Budgeting has been proved out in practice by many different undertakings and to-day, therefore, has a weight of practical experience behind it.

I propose in the first place broadly to outline a system of budgetary control and then to describe its uses and value to management. I am supposing the case of a holding company with a number of subsidiaries.

The exact details of any such system must be governed by the circumstances and nature of the particular business, but from the interchange of experience, as revealed by Mr. Dunkerley's paper, it is clear that we are all working upon very similar lines, and have adopted the same basic principles, in fact, a definite technique is being evolved.

There is nothing mysterious or complicated about such a system. In fact, it is extremely simple. It merely represents setting up a system for the purpose of estimating what results next year's Profit and Loss Account and Balance Sheet are likely to show.

To be of value to management, these estimates must be reasonably accurate and therefore great care and sound judgment are required in framing these forecasts and the system must be such that no known factors are overlooked.

As regards the period of the budget, this depends upon the nature of the business. Some concerns can budget a year ahead or even longer, whereas others can budget for only two or three months ahead.

However carefully the budget may have been prepared, events will rarely work out exactly according to the plan. There are many contingencies impossible to foresee which may drastically affect the results such as war, weather, fashion, price wars, booms, slumps, strikes tariffs, exchange restrictions, etc. It is necessary, therefore, for the budget calculations to be reconsidered and revised periodically.

In the case of our company, we budget for a year ahead and revise quarterly. This means that at the quarterly revisions the whole of the forecasts for the coming year are reconsidered and recalculated.

Our financial year is January to December, and our No. 1 Budget is submitted in the first month of the year, namely January.

The No. 2 Budget is submitted in May, when, of course, we have available the ascertained results for the first quarter.

The No. 3 Budget is submitted in August when the first half-year's accounts are available.

No. 4 Budget, the final revision, is submitted in November when the first nine months' results are known.

I suggest that the year's budget should be subdivided into monthly or quarterly periods, so that during the course of the year the ascertained results may be checked against the budget forecasts. This procedure is most valuable for checking the position during the course of the year, and greatly increases the control of operations and finance.

During the course of the year the actual position should be checked month by month against the budget predetermined positions—

Under our system the budget is split up as follows—

(*a*) Production budget.
(*b*) Trading and profit and loss budget.
(*c*) Capital expenditure budget.
(*d*) Finance or cash budget.
(*e*) Balance Sheet budget.

Each company or unit within the combine submits its budgets in this form and the whole of these individual budgets are combined into a master budget for the whole group of companies.

Production, Trading and Profit and Loss Budgets

The form in which these budgets are submitted corresponds exactly with the form of the annual financial accounts. In my opinion this is very important as it makes certain that no item is overlooked and it enables detailed comparisons to be made subsequently between the budget forecasts and the actual results.

The grouping of the items in this form of accounts should be by responsibilities. That is to say, that the expenses under any one group should be the sole responsibility of a particular department or section. If expenses of two or more responsibilities are grouped together, then each department, if criticised, will have an alibi.

The first step in the preparation of these budgets falls to the sales division which has to make the following estimates—

(*a*) The estimated sales in quantities.
(*b*) The estimated selling prices.
(*c*) The estimated selling and distribution expenses and charges.

In some cases the sales division would estimate the advertising expenditure, but more commonly the board decides the annual advertising appropriation.

(The whole budget is based upon, and directly depends upon, these sales estimates.) The great difficulty is in estimating the volume of sales of the various classes or types of goods, and also the effect of contingencies. I will refer later to the importance of this factor, which is the keystone of the arch.

Upon completion, the sales estimates are passed to the works director for the purpose of calculating the production costs to meet the forecasted sales programme. It is necessary, of course, in this connection to take into account predetermined inventory levels. It is, of course, a matter of vital importance that inventory levels should be planned in line with production and sales volume.

As regards the raw material costs, the chief purchasing agent will estimate these. In making this calculation he will have particulars of, and the value of, the stocks in hand, any forward cover and the prices at which such contracts have been fixed, and the only unknown factor and difficulty, therefore, is the prices in respect of the unbought balance.

In this connection budgeting enables purchasing to be planned according to a long-range view and therefore avoids, so far as is possible, the dangers and difficulties of over and under buying. It also enables materials to be bought to the best advantage.

The works director will estimate the direct labour cost and the works overheads, which latter will include all works charges up to the factory gate, all of which the works director controls.

In making these calculations, allowances must be made for the effects of altered processes, improved plant and improved labour efficiency.

A budget system enables production to be planned with a view to attaining a steady flow and it gives warnings of idle capacity and shortage of capacity and thus enables timely action to be taken.

Upon the completion of the production budget, the next step is for the accounts department to estimate the administration and financial charges, taxation, etc.

The final step is also as a rule undertaken by the accounts department, which is the assembly of all of these various estimates. As has been stated, the whole of the figures are built up in exactly the same way as the year end accounts, and the budget on completion, therefore, shows a Production Account, Trading Account, Profit and Loss Account and Appropriation Account.

It is important, of course, in framing these estimates that allowances should be made for any possible or probable year end adjustments, such as the writing down of inventories, provision for bad and doubtful debts, and exceptional losses and charges. When first starting a budget system, it is very common to find that these factors are overlooked.

Having assembled the figures in this way, the accountants would then work out the vital ratios such as percentages to sales of the cost of goods sold, gross profit, selling expenses, net profit, etc., and others such as the ratio of sales and net profit to capital employed. These ratios are of great value for the purpose of testing the calculations, and also when reviewing the figures.

The whole of the details of these budgets should be carefully compared with the actual results of previous years.

On completion, the budget of each concern should be approved by the manager, and in the case of a combine the group manager would approve of the budgets of all of the various concerns within his group, and the controller of finance would combine all of these budgets into a master budget for the whole combine.

The master budget would contain summaries, showing the final results, by groups, of each unit, and, for comparative purposes, the previous year's results. This master budget on completion would be approved by the managing director and chairman of the holding company, after which it would be submitted to the board for final approval.

In our case, the master budget submitted to the board consists of only a few foolscap sheets, but by a study of these summaries it is possible to see the trend and progress of each group, each unit within the group and the combine as a whole. When reviewing the accounts for the past year, on the board summaries, in addition to the figures for the year under review, comparative figures are shown for two preceding years and the budget forecast for the coming year, so that in this way the trend is clearly shown with both a backwards and a forwards view.

Each unit and group is studied in the same way, and thus the weak spots are clearly revealed. It is easy, therefore, to see where action is needed. During the year the statements showing the monthly profit and loss results of each unit should show also the budget forecast, so that month by month in this way progress can be checked against the predetermined positions.

Capital Expenditure Budget

By means of this budget a forecast is made of the capital requirements for the coming year. Each unit, therefore, has to consider its development plans ahead. Details should be given of the main items and the estimated financial gains, if any. The statement should be submitted showing the anticipated expenditure month by month, as these particulars are required in connection with the preparation of the finance budget which I will explain later.

Approval of a capital expenditure budget under our system does not give authority to expend the sums involved, but before actual expenditure can take place each proposal has to be sanctioned.

The capital expenditure budgets of all the various units will be combined into a master budget by the controller of finance. This master budget, therefore, shows the grand total involved.

The controller of finance would then prepare a report reviewing the budget, and stating how it is proposed that the total expenditure should be provided. It may be necessary for him to point out that if the total is expended that the result will be strained finances. In

the circumstances, the whole of the individual budgets may have to be revised downwards.

Here again after approval by the managing director and the chairman, the capital expenditure budget would be submitted to the board for final approval.

In our case, the capital expenditure budgets are revised half-yearly.

The preparation of these budgets results in long-term planning and effective control over capital expenditure. Experience shows that such a system also results in economy in the use of capital.

Finance or Cash Budget

This budget is based on the profit and loss and capital expenditure budgets. Its purpose is to show the cash balance month by month for, in our case, twelve months ahead.

In making the calculations, allowance has, of course, to be made for the lag in the collection and payment of accounts and also for capital expenditure and receipts and non-trading income and expenditure.

Under our system, this budget is revised quarterly.

By this means it is possible to see the cash position month by month for twelve months ahead, and therefore exactly when any peak loads will develop. If so, in good time the necessary finance can be arranged. On the other hand, the statement may show that at certain periods there will be surplus funds, if so, arrangements can be made for their investment.

I feel sure that it will be obvious to all of you the great value of this forecast of the liquid position which is such a vital matter. By means of this budget timely warning is given of any difficulties and therefore action is taken before the event.

If, therefore, these estimates are reasonably reliable, this budget will prove of inestimable value to management, as policy has of necessity to be governed by the state of the finances of the concern.

Personally I cannot imagine how in the case of a widespread organization it is possible to control finances effectively without some such organization, as without it the industrial ship may find itself on the rocks before we know that it is even in shallow water. The preparation of this budget is exactly like taking navigation soundings which, of course, are to ascertain what depth of water there is below the ship.

Balance Sheet Budget

The various budgets that I have already described, you will appreciate, give all the information necessary for the preparation of an estimate of next year's Balance Sheet. This completes the picture, and enables every financial aspect and trend to be reviewed.

The whole of the time involved in the preparation of these various budgets will be wasted if this machinery is not used. I would like to emphasize, therefore, the importance of checking the actual position

during the course of the year against the budget forecasts. If this is done, then management will have effective control over every aspect of the affairs of the business.

The accuracy of all these budgets, with the exception of the capital expenditure budget, depends directly on the sales estimates, so that when installing a system, it is most necessary to emphasize this factor. If the original sales estimates are wrong, then the whole of the subsequent calculations will be thrown out and the whole picture will be distorted.

A reasonable degree of accuracy in sales estimates is much easier in some businesses than in others. In some it is almost impossible to forecast very far ahead.

In my experience it is essential that the sales estimates should be prepared territory by territory by the local sales forces. These local estimates have, of course, to be reviewed and approved by higher sales management.

There are many difficulties, and one of the main ones is to estimate the volume of demand of the different classes and types of products in respect of which the profit margins may vary greatly. It is impossible to foresee exceptional demands, the effect of fashion, seasons, competition, etc.

The foundations of these estimates are past results and a careful market investigation. As regards the latter, public and trade statistics are of great value, and in this country industry would be greatly helped if these public statistics were improved, amplified and issued more promptly.

Additional information will be gathered from field reports from the various sales territories and from contacts with the principal customers.

Having gathered all of this information, consideration has to be given to general economic conditions and also those in the particular industry, other factors are advertising policy, and the effect of price policy on volume, in this connection greater quantity does not always mean increased profit.

The object of this investigation is to assess the potential market and the share which the particular business may expect.

The preparation of these sales estimates is of great value to management, as they serve the purpose of a measuring stick with which to judge sales efficiency. The preparation of these estimates enforces a regular survey of the whole sales problem and results, therefore, in a careful study of sales volume in relation to capacity and of inventories. It further concentrates attention on non-paying lines and experience shows that it results in the sales personnel becoming profit conscious.

When installing a budget system, it is common to find that executives become discouraged if the actual results prove to be wide of the estimate, but however carefully prepared, budgets cannot be expected invariably to work out exactly. If we think they will, we are merely

fooling ourselves, as there are so many circumstances and conditions which may vitally affect the calculations. With changing circumstances obviously it is necessary to alter the plan accordingly, but in that case all sections will change step together. This is the purpose of the quarterly revisions.

Advantages of a Budget System

Advantages of a budget system are that it forces every department to think and plan ahead, and therefore to work according to one carefully considered plan. By this means, each section keeps time with the other departments and so becomes part of a team. One of the great advantages, in my experience, is that it develops a team spirit.

Under the type of organization that I have described, you will see that each section is largely responsible for setting its own goal. The managers of these various sections know that achievement will be measured against the standards which they themselves have, in effect, set. It therefore gives an incentive to effort and also economy. There is, I think, no doubt that this type of organization makes executives cost conscious and profit conscious.

By means of the budget, expenditure is reviewed in advance and, therefore, before expenditure is incurred, management considers—

"What it ought to cost, and what we can afford."

In this way we avoid the piling up of uncontrolled expenditure.

These various budgets direct attention to the weak spots in the position in respect of which action is necessary, and they turn a searchlight on the results achieved by management.

When reviewing the final results, management is in a position carefully to consider whether these results are reasonable or not, and if not, what steps can be taken to improve the position. If losses are forecasted by a unit, management will consider whether such losses can be eliminated or reduced by reorganization or change of management, and alternatively whether it is worth carrying the unit on. In this way the leaks are stopped.

Such a system results in the co-ordination of all of the departments. It fixes responsibilities and acts as a yardstick with which to measure achievement. Further, it concentrates the attention of management on the effort to make profits. By this means also full use is made of our past experience in order to guide our future activities, and it substitutes considered intention for hit or miss guess-work.

Experience shows that such a system is invaluable for control purposes, both managerial and financial. When deciding policy management is in a position to see what the probable results will be, and is also enabled to see exactly how the position, as it develops, compares with the original plan.

Budgeting results in the whole financial position being kept under constant observation and control, and thus financial policy becomes

based on a careful survey of all factors and of the present and future trends. In consequence, it results in economy in the use of capital and also in revenue expenditure, and it avoids the fatal policy of drift.

By the introduction of a budgeting system the finance division is forced to turn round and be constantly looking forward. A common weakness in many businesses is that their accountants are merely looking backwards, but that viewpoint is not helpful to management. A further and very important benefit is that under this type of organization the financial organization becomes grafted into the whole system of managerial control, which enables the accountants to render far more effective service than is possible under the old-fashioned type of organization. There is no doubt that in this way the whole outlook of the finance division is broadened and its work becomes far more interesting and useful than ever before.

Budgetary control has a similar effect upon the other divisions and departments, to whom also the great importance of collective effort is made clear, as also is the part they play in, and their responsibilities for, the final financial results.

One of the great advantages in my opinion is that by means of the budgets we eliminate as far as is possible the element of surprise, and thus in bad times it helps management to keep its head, for it is the unexpected and the unknown that frighten us.

In conclusion, I would emphasize that a budget system is not a substitute for management, but experience shows that it is an invaluable aid. As a result of practical experience, I am convinced that such a system can be made an invaluable part of the control organization of a modern business.

Chapter XV

Financial Planning—Insuring for Future Profits

One of the Studd lectures on industrial and business management, delivered at the Regent Street Polytechnic in 1939.

THIS series of lectures is, I understand, intended to cover the financial requirements of administration. I gather that the previous papers have dealt with the financial background, both from the point of view of long and short period finance. The purpose of this paper is to consider the financial planning within a business itself, particularly with a view to the future.

In order that financial planning may be effective, it is essential that the organization of the finance division of a business shall be carefully planned, and further that this division shall be staffed by and controlled by the right type of personnel. The field that I am attempting to cover to-night is a wide one, as it embraces firstly, a description of the broad outlines of the system of organization of the finance division and the place of that division in the organization structure of the business as a whole. Having thus outlined the administrative machine, I hope to be able to describe to you how that machine is operated with a view to achieving effective financial control. The basis of financial administration, or course, must be forward planning, and I am sure that all will agree that financial administration, based upon a day-to-day outlook, has been the cause of many of our financial shipwrecks.

For the purposes of illustration, I propose to assume a holding company as, with this type of organization, this is a problem of paramount importance. In fact, it can be safely said that it is impossible effectively to administer such an organization without financial planning, backed by a complete and effective control system. In the case of smaller businesses, the principles are exactly the same, though the problem is less complicated.

The details of the scheme of organization of the finance division of a holding company require to be most carefully planned, as the finance division may be likened to the nervous system of the industrial body, by means of which it is operated and controlled. As in the case of the human body, any change affecting any part of the body should be signalled immediately to the brain if the nervous system is in good order. In the case of a holding company with wide ramifications, it will be appreciated that the setting up of an organization that will enable headquarters to keep in close touch with the exact position of every

unit presents a problem of great complexity and difficulty. It is essential, not only that the whole of the details of the system should be planned most carefully, but, in addition, it is vitally necessary that its operation should be under constant observation. Only in this way can success be achieved.

The evolution of the large-scale business of the present day is of comparatively recent growth and this expansion has created these administrative problems, which are very different from those involved in the administration of the small-scale business of our predecessors.

In industry, therefore, this evolution created a new problem upon which there was little experience. There was, however, long experience in administration on the large scale in the Services, Government Departments, the Church, and so on, though industry has, I think, been slow to appreciate that, the principles of administration being the same, there was a fund of experience in these directions that could have been drawn upon. In industry, therefore, we have all had to build up our organizations largely upon the basis of trial and error, but it is interesting to find that when opportunities arise to interchange experience, how most of us have developed upon very much the same broad lines. There are differences in detail, but the main structure is generally found to be upon a common basis.

Planning the Organization Structure

The main divisions of any industrial organization are—

(*a*) Sales.
(*b*) Production.
(*c*) Finance.

In the case of a holding company, each company within the group and the main company itself would be organized upon this broad basis. To be effective, it is of vital importance that the heads of the finance division shall be upon an equality of status with the heads of the other divisions, and that he shall report direct to the managing director of his company.

The finance division of each subsidiary and associated company would be headed by a local chief accountant and in the case of the main company, by a controller of finance.

The status, responsibilities and functions of the finance division, I would suggest, are as follows. The head of the division would be appointed by the board, on the recommendation, of course, of the chairman and managing director. In some cases, the head of the finance division of the main company has a seat on the board, whereas in others, although not a member of the board, he attends all board meetings at which matters involving finance are being considered. If the organization includes a central administrative committee, the controller of finance should be a member of that committee. It is of the

utmost importance that the controller of finance shall be in a position to speak with authority at the time when policy and plans are under consideration, so that the financial aspects may be appreciated fully by the board or central administrative committee before coming to decisions. Under the old type of organization in this country, the system commonly worked in the opposite direction, in that there was no opportunity for the head of finance to speak before decisions were taken; his time thus became devoted to looking backwards and the holding of inquests. Under modern practice, therefore, instead of merely looking backwards, the finance division is turned round and is constantly looking forward and taking an important part in the navigation of the industrial ship. This is obviously sound, as forward planning must be the basis of successful administration.

In the case of a large holding company, the various subsidiary and associated companies are commonly classified into groups and, in my opinion, it is most important that the organization of the groups and units should be upon exactly the same lines. That is to say, for example, that the chief accountant of each subsidiary or associated company should report direct to the managing director of that company and take part in the navigation of that unit in exactly the same way as does the navigating officer of each individual ship in the fleet.

Reverting to the controller of finance of the main company, he will be responsible for thinking out and laying down the details of the organization of the whole of his division. He would, therefore, decide the exact form in which the accounts of all units should be prepared and when they should be presented. He would also lay down the principles upon which such accounts should be prepared, with a view to ensuring that they are made up upon a common basis. For example, in consultation with the production divisions, standard rates of depreciation would be established for all types of plant used by the group of companies and, in like manner, the exact basis for the valuation of inventories would be laid down.

In order that the figures for the whole group of companies may be upon a comparable basis, which obviously is a matter of vital importance, the controller of finance should be responsible also for laying down the broad outlines of the whole of the accounting, costing and statistical system. Further, he should lay down a programme of dates when all accounts, returns and reports are to be submitted to headquarters. So far as possible, returns and statistics should be copies of those used by local management, and special returns for headquarters should not be asked for, unless there is a real need for the information.

Further functions of the controller of finance would embrace the general finances of the group, especially in connection with banking arrangements, investment of surplus funds, the arranging of banking accommodation, issues of shares and debentures, all taxation matters

and also the financing of subsidiary and associated companies. In addition, he would be responsible for many other special matters.

Under a budgetary control system such as I will endeavour to describe, the controller of finance would be responsible for the preparation of the master budgets for the group and for their presentation to the board of the main company.

The exact position of the controller of finance, *vis-à-vis* the local accountants of the various companies within the group, is a matter of importance. The local accountant is directly responsible to the managing director of his particular company, by whom he is appointed, though it is advisable that the controller of finance should approve of such appointments. The local accountant has a dual responsibility. That is to say, he has to furnish his managing director with all the information required and, at the same time, he is responsible for furnishing the controller of finance with accounts, returns, statistics, and so on, prepared upon the bases laid down by the controller of finance.

The accounts of a subsidiary will, therefore, be prepared by the local accountant and submitted to headquarters by the managing director of that company. From the headquarters' point of view, it is important that there should be some assurance that the accounts, as presented, have the approval of the local accountant. This position can be safeguarded by arranging that the local accountant shall be responsible for completing and signing a questionnaire on the annual accounts of his company. By means of this questionnaire, the local accountant certifies that the accounts have been prepared in accordance with the standard practice laid down by the controller of finance, and he (the local accountant) is fully satisfied as to the correctness of the whole of the figures presented, that there are no undisclosed reserves and that all contingencies have been fully provided for. This questionnaire should be submitted with the accounts to headquarters by the managing director of the particular company.

The books and accounts of the various companies within the group are generally subject to internal audit. The internal auditors would report direct to the controller of finance, and the purpose of the internal audit would, of course, be to verify that the system of book-keeping is effective, that it has been properly carried out in accordance with the rules laid down and, in addition, the internal auditors would make spot tests and enquiries. It would be their function also to make recommendations in cases where the system could, in their opinion, be improved. Here again, it is helpful to have a standard questionnaire, which the internal auditors would have to fill up on the completion of each audit and which would be submitted by them with their covering report. The managing director of the particular company should be supplied with a copy of the internal auditors' report, and the internal auditors should discuss this with the managing director before the report is submitted to the controller of finance, so that the managing

director has an opportunity to give his answers to any questions raised in the report and also so that he may be fully cognisant with its contents. In my opinion, it is most important that matters should be so organized that local management feels that the internal audit is helpful to them and that it is not, in any sense, a "spy" system.

Planning the System of Records, Budgets, and so on

The general accounting organization of a holding company obviously must be designed so that, at head office, the financial position and operating results of every unit within the group can be watched from week to week and month to month, so that the general trend may be under constant observation. It is only in this way that action can be taken before the event. The financial administration of a holding company is, as I shall endeavour to explain, greatly facilitated by a system of monthly operating accounts and statistics, combined with a system of budgetary control, as in this way, the present position and future trends can be kept under constant observation.

It is impossible for me, in the time available, nor do I think that it would be helpful for me to describe the details of the system of records which would be used for the control of such an organization. In broad outlines, the type of records that would be required at headquarters would be firstly, monthly profit and loss accounts or operating statements from each company within the group, these statements showing the operating results for the month, the corresponding month of the preceding year, the to-date position for the current year with the figures for the corresponding period of the preceding year. These operating statements should, I suggest, show, in totals, the net turnover, gross margin, selling and general administration expenses, special items and the operating profit or loss. The statements would also show the budgeted results for the current year with the corresponding actual results for the preceding year. It is also helpful if these statements show, for the same periods, the quantity sales and, in addition, the quantity stocks held and, in the case of a factory, the raw material cover.

In practice there would, of course, be many statistical returns—weekly, monthly and quarterly—the purpose of which is to enable headquarters to watch the main trends.

A budgetary control system is of the greatest assistance in connection with the administration of a group of companies. In the time available, it is, however, impossible for me to outline this in detail. Under such a system, each company within the group at the commencement of each accounting year or period would submit a profit and loss budget. The first step in the preparation of this budget is a forecast by the sales department of the estimated quantity sales for the year or other period for which the budget is prepared. The sales department

would also submit an estimate of the level of selling prices and the selling and distribution expenses.

The next step is for the works director to calculate the cost of production of the forecasted sales volume, the estimated cost of raw materials being supplied by the chief purchasing agent.

The budgets are generally finalized by the chief accountant of the particular company, who will provide an estimate of the administration and financial charges, taxation, and so on.

When complete, the budget of each subsidiary company should be submitted to headquarters by the managing director of the particular company, together with a covering report.

The controller of finance would be responsible for the preparation of the master budget embracing those of all the companies within the group and, in due course, the master budget, after approval by the chairman and managing director, would be submitted by the controller of finance to the board of the main company.

These budgets would be revised quarterly or half-yearly, when a similar procedure would be carried out, except that, in making up these revised estimates, the actual results to-date would be available. The great advantages of a budget system, such as I have described, are that all sections of a unit are working to a common plan and, if the budget plan has to be revised, then all sections will change step at the same time.

Budgeting forces all sections to think and plan ahead, and a study of the budget shows, for example, whether it is likely there will be a shortage or a surplus of capacity during the period. Production capacity programmes, buying production, personnel, finance, selling and distribution programmes will all be planned ahead to meet the budget programme. This must result in effective co-ordination and control and makes it possible to take action before the event.

Obviously, there are many contingencies which can completely uspet the most carefully prepared budgets, but a budget system, combined with monthly operating results, enables a very close watch to be kept on the main trends. In the case of a holding company, the progress and position of each unit can be watched in this way. If the trends are not satisfactory, corrective action can be taken and so the affairs of the whole group can be effectively controlled by management.

In addition to the profit and loss budgets, a finance budget also should be prepared, the purpose of which is to show, for each company within the group and also the main company, the forecasted cash position month by month for say 12 months ahead. These estimates are based on the profit and loss budgets and budgets showing forecasted capital expenditure.

This budget obviously is of the greatest assistance in connection with the financial control of the group and of each unit within the group, as it will reveal the estimated financial peaks and valleys, which will

enable action to be taken in good time for the investment of surplus funds and, what is more important, with a view to arranging the necessary finance for the peak loads.

Under such a scheme as I have described, the controller of finance is in a position to furnish the chairman, managing director, the heads of divisions and the board of the main company with all the information necessary to control the affairs of the company.

Reports would be prepared by the controller of finance upon the periodical accounts of the various companies reviewing the current operations compared with those of preceding years and the budget for the coming year. In this way, the higher management is able to see clearly the main trends and is thus enabled to keep in close touch with all the main factors. Obviously, where matters are not progressing satisfactorily, special investigations would be carried out, with a view to ascertaining what action is possible, in order to improve the position.

The controller of finance would also be responsible for the preparation of the final accounts of the main company, for submission to the shareholders. The form of presentation of published accounts in this country has been greatly improved in recent years and, in the case of holding companies, the practice is rapidly growing of presenting a consolidated earnings statement and a consolidated statement of assets and liabilities. In my view, by far the more important document is the consolidated earnings statement, whereby the total earnings of the whole group of companies are shown and reconciled with the earnings of the main company.

The reading of the annual accounts is greatly assisted by grouping the items and by showing the corresponding figures for the preceding year. Some companies also publish with their annual accounts statistical statements showing the vital figures for a period of years, so that the main trends may be clearly seen.

Planning the Financial Structure

I now propose to outline the main considerations in connection with the planning of the financial structure of a holding company.

It is necessary, on the inception of such a business undertaking and also in connection with every programme of expansion, to estimate the capital required in order to finance its operations, and these capital requirements can be classified under two broad headings—namely "Fixed Assets" including investments in subsidiaries and "Working Capital."

If the main company is to undertake manufacturing operations and, therefore, production capacity has to be provided, very careful estimates will have to be made as to the capital requirements. The same considerations will arise in the case of each subsidiary company.

For this purpose, therefore, an investigation will have to be made,

with the object of assessing the potential of the particular market and the proportion that the company under consideration may reasonably expect to obtain. This calculation will give the estimated volume of production, for which capacity has to be provided. The effects of a miscalculation may be very serious as, if the volume attained falls far short of the estimate, the result will be idle capacity, the cost of which may prove to be a disastrous burden. On the other hand, if the capacity is inadequate, the business obviously will be hampered until additional capacity is provided, and it may not then be possible to arrange this so effectively or economically as could have been done in the first place.

Other considerations naturally which have to be taken into account are the location of the factory and, in this connection, important factors are the sources of raw materials, the situation of the market, labour supplies, rating, power facilities, facilities for expansion, and so on.

Having erected or acquired the factory, the next consideration is its equipment with plant, machinery, and so on.

Before authorizing any such plans, the board of the company would require a full memorandum, supported by careful estimates of the total cost of the whole of these fixed assets.

The next consideration is the amount of working capital required, which may be an even more difficult calculation to make.

The total working capital required will naturally depend upon the volume of sales and financial provision must be made for the peak loads that have to be carried at certain seasons of the year. The total required has to cover the investment in inventories, book debts and a working bank balance. The level of inventories, which in a manufacturing business embrace stores, raw materials, process and finished goods, depends upon the nature of the business and the facilities and the period required for replacement. The level of book debts depends on the volume of sales and the average credit terms upon which the goods are sold.

Part of the working capital is commonly provided in the form of trade credits. In the Balance Sheet of the concern, the working capital is represented by the surplus of current assets over current liabilities, which latter include trade creditors, bills payable, accrued charges and short-term loans.

The financial investment in inventories is a more or less permanent one, as inventories represent a reservoir which has to be kept filled, although the total amount does rise and fall in sympathy with the volume of production and sales. A sound position in this regard is for there to be a surplus of current assets, excluding inventories, over current liabilities.

In the case of subsidiary companies, the main company may acquire an interest in an existing business by the purchase of a majority

shareholding, or it may set up a new business to be operated by a subsidiary company. In the latter case, if a manufacturing business is to be set up, then exactly similar calculations and estimates will have to be made, in order to arrive at the total amount of capital required.

When the total capital requirements have been calculated, it will also be necessary to make careful estimates of the probable earnings, with a view to ascertaining whether the anticipated return justifies the investment. For this purpose, a budget will have to be prepared, showing the estimated profit margin upon the forecasted sales volume and to relate this profit to the estimated capital required.

Having arrived at the total capital requirements, the next consideration naturally is as to the form in which the capital shall be raised. The various forms in which capital is provided are, of course, share capital of various classes, debentures, bank loans and trade credits and, in addition, a continuing business may provide capital for expansion by means of reserves. The form in which the total capital has been provided obviously may have a considerable influence in the future upon the finances of the undertaking. In principle, it is obviously wise that the investment in fixed assets shall be covered by long-term capital, i.e. share capital and long term debentures. Wherever possible, the safer course is for the whole of the fixed assets and an adequate working capital to be covered by share capital only. This, however, is not always possible, as the form in which and the amount of the capital that can be raised depend on the financial standing of the undertaking and the condition of the money market at the time of the issue.

Debentures which, in the case of a commercial company, most commonly entail a floating charge over the whole of the assets of the concern, naturally affect the company's credit as, if disaster overtakes it, a receiver will be appointed by the debenture holders, when the position of the ordinary creditors may be far from a happy one. Unless, therefore, a company is in a very strong financial position, the issue of debentures may hamper it seriously in connection with its dealings with its suppliers.

Bank loans, whenever possible, should be utilized only for the purpose of financing temporary requirements which are self-liquidating. The financial position may become very difficult indeed if bank loans are ultilized for the purpose of the acquisition of fixed assets.

Trade credits should be kept in a balanced ratio to current assets and, as I have already said, it is prudent, if possible, to maintain a surplus of current assets, excluding inventories, over current liabilities.

If an undertaking is successful, it is obviously a wise policy to plough back profits into the concern in the shape of reserves, thus increasing the financial strength of the undertaking and enabling expansion to be financed out of reserves.

The working capital position is one which should be kept under rigid control and constant observation. This position, in a continuing

business, is constantly altering. The working capital available will be reduced by the cost of additional fixed assets, the repayment of debentures and loans and by trading losses. On the other hand, the working capital will be augmented by increases in the company's capital, the proceeds of sale of capital assets, the accumulation of undistributed profits and by provisions for depreciation and obsolescence.

It is very necessary, therefore, when considering additional capital expenditure, to take into account the effect that this will have upon the working capital position. Policy naturally has to be governed by the state of a company's financial resources, and uncontrolled expansion has been the cause of many financial disasters.

A holding company has commonly to provide for the financing of its various subsidiaries. In this way, it acts, in fact, as the banker for the group and thus the share capital invested in a subsidiary is often augmented by advances from the main company. The financing of subsidiaries in this way, however, should be strictly controlled.

In my experience, it is unwise to arrange matters on the lines of a general current account as between the subsidiaries and the main company. The wise course, I submit, is that the ordinary trading transactions as between the main company and the subsidiaries should be on an arm's length basis—that is to say, a period of credit should be fixed and the subsidiary company should be expected to liquidate its current account strictly in accordance with this arrangement. If additional permanent capital is required, this should be provided by the main company on a fixed loan account and there should be no authority for this loan account to be increased without the sanction of head office. The financial position of each subsidiary would thus be under the constant observation of the controller of finance of the main company, and if surplus funds are accumulating in the hands of the subsidiary, the main company would require these funds to be utilized in repayment of part or the whole of the fixed loan account.

It is very necessary to make it clear to the management of a subsidiary company that they are not trading with an open credit. On the other hand, it is obviously necessary to see that each subsidiary has adequate capital with which to finance its operations.

The general policy of most holding companies is to maintain surplus funds with the main company. It is for this reason, therefore, that surplus funds in the hands of subsidiaries are commonly deposited with the main company. In this way, the main company accumulates a fund of liquid capital which can be made available wherever it is needed within the group.

It is obviously necessary that there should be strict control of capital expenditure. For this purpose, a sanction system is most helpful. As a rule, the managing director of each company would be authorized to sanction expenditure up to an agreed limit and all expenditure beyond that limit would have to be authorized by headquarters.

All schemes involving capital expenditure above the local limit would be submitted to headquarters, with full particulars of, and the reasons for the scheme being given, together with the amount of capital required and the financial benefits, if any, that are estimated to result. As a rule, the chairman of the main company would be empowered to authorize expenditure up to an agreed limit, and the expenditure beyond that limit would be authorized by the board of the main company.

In a like manner, any scheme for the acquistion of additional subsidiaries would be submitted, for authorization, to the board of the main company.

You will have observed that the title of this paper is "Financial Planning—Insuring for Future Profits." None of you, I feel sure, will imagine that I am suggesting that any form of administrative machinery can make certain of future profits. The best laid plans may go badly astray; but it is far better to have worked upon a plan that miscarries than to have no plan at all.

Planning must be the basis of effective administration, and planning is necessary in every division and section of an industrial undertaking. In the long-run, the most successful business will be the one that is planning furthest ahead and that has the most efficient control system. It is in this way that financial planning assists management to achieve profits.

Financial planning is not a substitute for management but it is a most effective tool of management.

Judgment plays a vital part in the successful conduct of the affairs of industry, but before judgment is exercised and final decisions are taken it is most necessary that management shall have knowledge of all of the important factors bearing upon the matter under consideration. This is the function of a scheme of organization such as I have endeavoured to outline. There is nothing new or revolutionary in the scheme I have described—in fact, it is, so far as I can ascertain, the broad basis upon which most holding companies operate—but it has this merit that it has been built up, step by step, tested and proved in the hard school of experience.

Chapter XVI

Financial Planning and Control

A paper delivered before the Department of Industrial Administration of the Manchester Muncipal College of Technology on the 28th November, 1946, and before the South Wales and Monmouthshire Society of Chartered Accountants on the 7th November, 1946.

THE subject we have to consider this evening is the part that financial planning and control plays in the management of the large scale business of to-day. It is a vital part, as under our existing system of private enterprise the ultimate test of successful management is, after satisfying customers, suppliers and employees, the earning of a reasonable return upon the capital employed.

Finance weaves its way through every activity of a business and may be likened to the sinews of the human body. If the finances of the industrial body become unhealthy and diseased the consequences, all too often, prove to be fatal. Thus the effective control of finance is one of management's vital problems.

The word "planning" has an ominous sound in the ears of many industrialists to-day. During those long and dreadful years of war, every aspect of both their lives and businesses was planned and controlled; this they suffered without complaint as part of their contribution to the war effort. But in those dark days they fondly hoped that, upon the termination of hostilities, they would be able to return to a much freer and more individualistic life. But that happy day has not arrived yet and many doubt whether it ever will. One can well imagine such an industrialist pleading, "I have the planners still at work outside my business, please do not bring them inside as well!"

Many industrialists would point to most successful concerns that have never had a complicated planning system and to captains of industry who have made far more correct decisions than wrong, although such decisions were based largely upon intuition and not upon a study of detailed facts and figures. There undoubtedly are such men, but even they would find it very difficult to be equally successful if they were in command of a large scale and widely dispersed business.

But, I submit, that in fact every business big or small always has and does and must plan ahead. It is just as much the basis of successful operation in industry and commerce as it is of a military operation in time of war.

For example, let us suppose the case of a man who contemplated earning his living as a costermonger. He would have to plan on the following lines—

(*a*) should he buy his barrow or hire one?

(b) If he decided to buy, he must consider how to provide the necessary capital for the purchase of the barrow and the first stock of goods. If he had not the necessary amount, should he try to borrow, or provide the finance out of the proceeds of a well-planned burglary!

(c) He would have to decide what goods to trade in and in what district and by what methods to sell them.

Admittedly, however, in such a business no complicated system would be required for its management and control, for the one man would be responsible for all functions, i.e. buying, selling, transportation, personnel, finance, accounting, etc.

Let us further suppose that this man was highly successful, saved money and then took a shop, eventually owning a chain of shops all over the country together with farms and factories which supplied the products he dealt in.

Upon this expanded basis the problem of organization would immediately become of supreme importance. He would be forced to delegate responsibilities and success would not be possible without sound financial planning and control.

In the past, and in fact in far too many businesses to-day, management has based its plans upon a rough-and-ready survey. For this purpose the accountant generally provided historical figures dealing with the operations of the past. This is a great weakness, as the accountant who is always looking backwards can render little effective help to management in the navigation of the industrial ship.

Careful and detailed planning is the basis of all successful operations in every sphere of life. It is necessary therefore to set up an organization for the express purpose of carrying out this vitally important function. The whole of the ground must be surveyed, every factor, present and future, must be considered and responsibilities must be clearly defined.

By means of such a plan, management sets the objective for the future operations and every section of the business is thus attuned to this one plan. As the plan develops, the progress of the whole operation and of every section is constantly checked against the predetermined plan and if not in accord, where possible, corrective action is immediately taken by management. Only in this way can any operation be effectively controlled. In the large scale business concern of to-day this function is of vital importance. Under this system all management decisions are based upon a careful and scientific review of all factors. Judgment still plays its important part but it is exercised in the light of a complete knowledge of all the surrounding circumstances. Furthermore it is only by such means that it is possible to keep all of the activities of a large business under proper control.

In the time available to-night it is possible for me to describe in the

broadest outline only the type of organization that is required. I cannot therefore deal with the details of such a planning scheme.

Essential preliminaries that must be pre-supposed are that there must be a complete and efficient accounting, costing and statistical system throughout the business. Further, the head of the finance division of the business must be upon an equality of status with the heads of the other main divisions of the concern and he must report direct to the chief executive officer of the business. The financial controller must be in a position to speak before decisions, involving finance, are taken. Under the old type of organization his responsibility was mainly confined to holding inquests after the event.

A further necessary condition is that there must be complete and effective co-operation between all sections of the business in the preparation and operation of the plans.

Careful financial planning is necessary when a business undertaking is first established. An estimate must be made of the amount of capital required in order to provide the necessary fixed assets and working capital. If serious errors are made in framing these forecasts, the consequences may be grave. Such calculations, therefore, should be based upon a complete and careful survey of the whole proposition. A vital figure is the estimated volume of production for which capacity has to be provided. This figure will govern the cost of the main fixed assets and also the requirement for working capital. If the estimated volume proves to have been far too optimistic, then the concern will be heavily handicapped and burdened with the cost of idle capacity. If on the other hand the estimate is far too low, then management is immediately faced with the necessity of extending capacity, which is costly and inevitably disturbs current production and, it may be, finances.

Having settled this estimate of the total capital required, the next decision is as to how such total shall be provided, i.e. by way of ordinary and preference share capital, debentures and trade credits. These decisions must directly affect the future of the business and, if judgment proves to be faulty, the consequences may be serious.

In this connection, therefore, careful planning is obviously necessary, but it is chiefly the planning in connection with the running of an industrial business which I wish to discuss to-night.

Financial planning is effected by means of a system of budgeting and standard costing. It is in fact all one system and it has been said that every budget is a standard and every standard is a budget. These terms have been generally accepted as describing two parts of a system of financial planning and control. The term "budgeting," however, is generally used to describe the predetermination of the overall trading results of a business for future periods, in other words it is an estimate of next year's Profit and Loss Account. From the manufacturing point of view it is necessary to break down the production figures contained

in the budget into separate budgets or as they are called "standards" for each production unit and service throughout the factory. Standards are also established throughout the sales division. In this way targets are set for each and every part of the production and sales divisions, and these targets must all be realized if the overall budget results are to be achieved. The great value of this setting of standards is that by this means actual achievement can constantly and immediately be measured against the predetermined standard. Management thus instantly becomes aware of the fact of the overall results being in accordance with the plan or not, and what is far more important, the exact sections in which matters are not developing according to plan. This is the vital information that management must have, if effective control is to be achieved. Where matters are progressing according to plan, management is not concerned, but immediately progress in any section of the operations is out of line with the plan, then management is directly concerned. In order to achieve success every section of the whole operation must be in correct balance or "in step" to use a military term. If it is not, then management must immediately take action to bring all sections into line, either by accelerating or slowing down the particular section, or if that is not possible by altering the pace of all of the other sections, so as to maintain correct timing throughout the whole operation. Thus the original plan may be changed by reason of uneven timing by certain units.

The setting of standards gives an incentive to achievement which, experience shows, has a most stimulating effect upon individual effort. In this respect it is exactly similar to the fixing of "bogey" for each hole on a golf course. By that means, as each hole is played the golfer has a measure of his achievement. When the round has been completed the player can see from his card how his total score compares with "bogey" for the course, and if it varies he can see how the total variation is made up of pluses and minuses on individual holes, and he will know the reason for those variations. The whole purpose and effect of a budgeting and standard costing system is exactly similar and undoubtedly results in the "lowering of the handicap" of an industrial organization. Management by this means learns how to correct past errors and how to improve and develop technical efficiency throughout the whole organization, just as the golfer directs effort towards improving the weaknesses in his game as revealed by constant comparison of his efforts with the "bogey" score.

In order to achieve the desired results all standards should not be imposed from above, but should be agreed, as being fair and attainable, by the individual whose achievements are to be measured by that standard. To set an impossible standard will inevitably dishearten and result in a feeling of unfairness in the mind of the individual concerned.

The whole budget plan in all its details, therefore, should be evolved

as a result of collaboration and consultation between higher management and those in command of the various sections.

The financial controller usually co-ordinates the whole of this work and prepares the master budget, but the budget is built up and based upon the individual standards agreed with the executives in charge of the various divisions and sections of the undertaking.

The main budget should not be prepared upon the basis that every factor will be favourable. Such a plan would represent an impossible ideal. The budget forecast, therefore, should represent a reasonable and fair expectation of attainable results. The preparation of a business budget may be likened to the working out by the navigation officer of a ship of the course ahead against which, during the voyage, the ship's position is constantly checked. Only in this way can a ship be safely navigated through the seven seas. Likewise it is only possible, by similar methods, to navigate safely the industrial ship.

The first step in the preparation of a budget is an estimate of the sales of individual products in quantities, prepared by the sales division. This is the basis upon which the whole budget rests. This forecast is founded upon a careful survey of past results, market research, area reports, etc., combined with a consideration of general economic trends, etc.

The sales division next have to estimate the prices at which it is expected that the goods included in the estimate will be sold. Further, a forecast must be prepared showing the estimated cost of selling and distributing the quantities planned for.

The quantity estimates are next considered by the production division. It may then appear that there is a deficiency of production capacity to meet the sales forecast. This would entail a consideration as to whether production capacity should be increased, whether subcontracts should be placed, or the sales plan should be reduced to fit the manufacturing capacity.

If on the other hand the sales estimates revealed a considerable excess of production capacity, this would call for a reconsideration of the whole sales policy. The price policy would require reviewing and it might be that reduced prices might be decided upon if they were estimated to increase quanity sales. Credit terms and marketing methods should be reviewed and also the possibilities of developing new markets and new products.

When the sales plan is finally settled, the production division would prepare estimates of the production cost of the planned volume. This would involve estimations of the direct material and labour costs and also all production overheads.

The foregoing estimates would then pass to the financial controller who would prepare estimates of the administration, financial, taxation and other expenses and charges.

In this way the profit and loss budget is completed, thus showing the predetermined trading results for (say) the coming year.

At the same time a capital expenditure budget would be prepared. For this purpose all divisions and sections of the business would be required to forecast their capital expenditure requirements.

Upon the basis of the profit and loss budget and the capital expenditure budget, the financial controller would prepare a cash budget, showing for (say) the coming twelve months the estimated monthly cash position of the business.

Upon completion this budget may show up red lights. For example, in a time of great trade activity, it may reveal clear signs of overtrading and severe strain upon the financial resources of the business. Thus management would be forced to reconsider the whole plan and this might result in a reduction in the sales programme or the working out of plans for the provision of extra capital to finance the increased burden of the forecasted volume.

The careful planning of finance and the constant checking of the position is obviously of surpreme importance.

As soon as all of these budgets have been settled, it is possible then for the financial controller to prepare an estimate of next year's Balance Sheet.

In this way, therefore, every aspect of the financial operations for the coming year or period is carefully surveyed and planned and management is enabled to review and control the whole position. The executive programme of every section of the business would be based upon the one plan and thus correct timing and balance throughout the organziation is ensured.

But events will rarely work out exactly according to plan and therefore the budget system must be flexible so that it can be adjusted to meet altering circumstances. For this reason there must be means by which the budget can be revised and thus every section of the business "changes step" together. Only in this way can correct timing be maintained.

The main budget having been settled, the production division will then proceed to fix their standard costs for every production centre and service.

The standard time that each operation of production should take is established by careful time and motion studies, which are of course highly skilled and technical work. These standard times are then expressed as "Standard Hours"—one standard hour representing "one hour's worth of productive work." Standard hours are then used as the basis on which costs are established, and as a measure by which to gauge actual production costs against standard costs per standard hour. At the same time actual production times are compared with standard times.

In this way, throughout the factory, measuring sticks are set up by means of which management can measure every operation in terms of time and expense. Thus "bogey" is set for every "hole" that

production plays. Similar methods are also applied for the control of the sales division.

You will appreciate that by means of the main budget and the standard costing system, management is enabled to see the differences between the predetermined and the actual results, but that is not sufficient for management purposes. In the past that is the point at which nearly all of our systems stopped. But if we accountants tell management that this month our earnings are 20 per cent below budget or that the costs of a particular process is 15 per cent above the standard cost, management's immediate enquiry will be "what are the reasons for these adverse results? Why have not results been according to plan?" Only if we can supply the answer to these enquiries will our control system be an effective tool of management.

It is for this reason that all modern developments in this field have been upon the lines of organizing our budget and standard costing system, so that we can isolate and find the reasons for all the variances from the predetermined plan. Such information, provided that it is prompt, is of the utmost value to management and enables corrective action to be taken promptly.

These variances are divisible under many different headings, some controllable and some not. Those that are controllable must be traced to the executive responsible for them and the reasons ascertained. The following are examples of variances—

(*a*) Volume.
(*b*) Materials—price.
(*c*) Materials—usage.
(*d*) Direct labour:
    1. Rates of pay.
    2. Efficiency.
    3. Extra allowances.
(*e*) Calendar.
(*f*) Seasonal.
(*g*) Overheads:
    1. Expense.
    2. Volume.
    3. Efficiency.

The foregoing are merely examples and there are many other variances, a most important one being machine usages, but the point I wish to underline is the great importance of organizing our systems of control so that all variances from budget or standard are isolated. The reasons can then be ascertained and responsibilities fixed.

A further great advantage of this type of organization is that it throws up clearly the cost of idle capacity, or to put it another way the cost of *not* doing work. Under our old-fashioned costing systems, this

important cost was smothered up in faulty methods of spreading overheads. If the cost of idle capacity is clearly revealed it at once forces management to consider what action can be taken to find work to turn the idle wheels of production.

It is of the utmost importance that cost information shall disclose not only the standard cost of a product at a normal level of operating activity and efficiency, but also the marginal cost of the product, i.e. eliminating all fixed overhead charges. This information can be obtained if the process costing rates are budgeted in a manner which isolates the fixed charges allocated to individual manufacturing processes. When the present sellers market changes into a buyers market both at home and abroad, it will be of vital importance that management has this information available.

I have endeavoured to describe in the broadest outline the modern principles of financial planning and control. This is, however, not a new idea but is one that has been tried out and proved in the hard school of practical experience over a period of some years.

Such a system makes sure that every section of an industrial undertaking is operated in accordance with a carefully thought-out plan—production, personnel, buying, selling, distribution, finance, etc. As the plan is put into operation management is enabled effectively to exercise control as all variations from the plan are promptly disclosed. Management is thus in a position to correct adverse trends before they have developed into what might prove to be disastrous proportions. In short, such a system results in action before the event in place of inquests afterwards. But in order that such a system may be effective there must be wholehearted co-operation from the managing director down to every foreman and operative in the factory and every salesman in the field.

In conclusion I would like to sound one word of warning. It is very easy for all of us who become enthusiastic supporters of these modern management methods to lose sight of the most important factor in this whole management problem. We so easily overlook the vital factor of leadership which is the only means by which the breath of life can activate what otherwise is an inanimate body. Only by inspired leadership from the top can any group of men and women be fired with the impulse to co-operate fully and to give of their best. A faulty system of planning and control combined with brilliant leadership will result in great success in achievement. But the best system in the world with bad leadership will probably result in dismal failure. How to obtain full co-operation throughout an organization is the great unsolved problem facing society all over the world. Upon this all-important point may I read to you three quotations.

The first is from a brilliant paper by Lt.-Col. L. Urwick read before the conference held in London in October last of the Institute of Industrial Administration. In this paper he stated that the central problem

facing society to-day was how "to correct the terrible lack of balance between our technical knowledge of how to make this and that, of how to conquer space and time, and our ignorance of how to organize even the smallest system of co-operation so that men are satisfied in their work and happy to give of their best. We have learned how to split the atom and thus release its destructive energy. We do not know even the beginning of putting our social groups together so as to release a tithe of the constructive energy, which is possible with true co-operation."

My second quotation is from a book by Alan Moorehead on the life of Field-Marshal Montgomery, in which there are quoted principles that he annunciated before the late war when instructor at a military staff college in India. The basic principles of military operations he laid down as follows—

"*No.* I. *Morale.* Study the individual soldier. Create the atmosphere of success. Morale means everything.

"*No.* 2. *Simplify the problem.* Sort out the essentials which must form the basis of all future action, and once you have decided upon them ensure that those essentials stand firm and are not swept away in a mass of detail.

"As a commander, lay down the general framework of what you want done—and then within that framework allow great latitude to your subordinates. Stand back yourself.

"*No.* 3. You must learn how to pick a good team of subordinates, and once you have got them stick to them and trust them.

"*No.* 4. Make yourself know what you want and have the courage and determination to get it. You must have the will to win."

If you change the word "soldier" for "employee" and the word "commander" for "manager," how surprisingly those principles apply to industrial operations. And note that he places morale as No. I, and says that "morale means everything."

My third quotation is from a recent statement by Sir Stafford Cripps and which is that "morale in industry can be studied as scientifically as was the morale of the troops in time of war."

There, I am sure you will all agree, is the key to nearly all our social and industrial problems. We have not found that key yet, but we must hope that we shall before it is too late.

SECTION III

MISCELLANEOUS MATTERS

Chapter XVII

The Future of the Accountancy Profession

A paper delivered at a Joint Meeting of the Liverpool Chartered and Incorporated Accountants, on 23rd March, 1943.

At the present time all men's minds are greatly exercised regarding the vital and gigantic problem of reconstructing our shattered world upon the termination of this terrible war. It is therefore very necessary, I suggest, that we accountants should take stock and carefully reconsider the whole of the organization of our profession in order to ensure that it is ready and fit to play its part fully and effectively in the difficult period that lies ahead of us.

Some of you may feel that now is not the time for this, and that any question of the reorganization of our profession should be left over until after the termination of the war, when the younger members will have returned and be able to voice their views.

I would urge, on the other hand, that we should hasten to put our house in order in anticipation of the return of our gallant young members so that they may find the condition of the profession as sound and solid as we can make it. They will no doubt have many further improvements to suggest after they have settled down to civilian life.

Furthermore, our profession has expanded and grown so rapidly that we have had little time or opportunity to sit down and carefully review our progress and make sure that our ship is well founded and upon a safe course. In all the hurry and pressure of our busy lives I feel that there is a great danger that we may accept it without question that all is well. It may not be.

For all of these reasons it would seem desirable that we should carefully review the present position in the light of the future responsibilities of the profession so far as they can be foreseen.

Before we consider the future, however, I think it will be helpful for us briefly to survey the past, in order to see what lessons can be learned for our future guidance. At the same time we should also, I suggest, endeavour to profit by the long experience of the older professions.

It is salutary and chastening to remind English accountants that accountancy as a profession started in Scotland. As you know, the Society of Accountants in Edinburgh obtained its Charter in 1854, followed by Glasgow in 1855 and Aberdeen in 1867.

In England, I have recently discovered that the first Association

of Accountants was formed in 1870 here in your City of Liverpool and four other associations quickly followed your lead.

In 1878 the five English associations promoted a Bill in Parliament to close the profession. Owing, most unfortunately, to opposition threatened from the Lords, it was decided to apply only for a Charter which was granted in 1880. In 1888 the Institute of Chartered Accountants in Ireland was incorporated and the Society of Accountants and Auditors was founded in 1885.

Later on, as we all know only too well, many other societies of accountants were formed and the Board of Trade committee appointed in 1930 to consider the question of registration for the profession had to hear evidence from twelve societies of accountants in addition to the Chartered and Incorporated Accountants. In their excellent book on *The Professions*, Messrs. Carr-Saunders and Wilson state—"It is the multiplicity of competing associations of independent practitioners which is the distinctive feature of the accountancy profession."

This position, all will agree, is far from satisfactory, and in the past several Bills were promoted without success for registration for the profession; the last one in 1930.

Undoubtedly at this late stage this problem is extremely difficult and complicated, but I suggest it urgently requires reconsideration, not from a sectional but from the widest point of view. The basic consideration, I submit, should be solely what is best for the future welfare of the profession taken as a whole. That, therefore, is the first point which seems to me to need careful consideration.

The profession has undoubtedly developed and expanded in directions not foreseen by its founders. For example, in the Charter of the Institute, in describing the activities of accountants, the first references are to their acting as liquidators, receivers and in "positions of trust under Courts of Justice" and lastly to their acting as auditors. Accountancy was not mentioned.

From the above narrow conception of its activities the profession has moved far. "The part played by the accountant in the economic life of this country has become one of great importance . . . he has become what has been happily described as the medical consultant of industry." (Carr-Saunders and Wilson.)

The field, therefore, has widened far beyond merely auditing, liquidations and receiverships, and embraces the giving of advice regarding financial policy, management problems, costing, business organization, reconstructions and many other matters. In addition to which accountants have specialized in taxation matters and this in itself has opened to us a vast field of activity. Accountants are also commonly found upon government committees, upon the staffs of government departments and as advisers to trade and commercial organizations. In fact, there are few matters affecting the economic life of the country upon which accountants are not consulted.

In addition, accountants nowadays are playing an important part in the direction of management of industry. They are to be found as members of the boards of the majority of companies and in many cases as full-time managing directors.

A further most pronounced trend in recent times is that of the full-time employment of professional accountants within industry and commerce. In that capacity they have revolutionized accountancy practice, they have played an important part in the movement towards more informative accounts and they have created one of management's most effective tools of control. It is impossible to direct and control effectively the large-scale businesses of to-day without complete and efficient accounting, budgeting, statistical and costing records. In industry these systems of control may be likened to the nervous system in the human body by means of which every change affecting the body is immediately signalled to the brain.

All the foregoing activities are in addition to those originally laid down by our founders, i.e. liquidations, receiverships and auditing.

Naturally, in order to meet these increasing responsibilities the profession has grown rapidly. For example, in 1880 the total membership of the five English associations applying for the Charter was 500. In 1913 the total membership of the Institute was 4,671 and by 1939 it had grown to 13,481, so that in twenty-six years the total membership of the Institute alone had been nearly trebled.

It might be interesting to study the proportions in which the 1913 and 1939 membership is divided. They are as under—

	1913 %	1939 %
In practice	60·5	39·0
Not in practice	27·5	51·5
Abroad	12·0	9·5
	100·0	100·0

The great increase in the proportion of accountants not in practice is no doubt largely caused by the drift of qualified accountants into industry.

The secretary of the Society has been good enough to supply me with similar figures for his Society for 1913 and 1942. They show almost exactly the same trends.

The total membership rose from 2,623 in 1913 to 7,886 in 1942, so that in this period the total membership had also trebled as in the case of the Institute.

The classification of these totals is as under—

	1913 %	1942 %
In practice	46·5	31·0
Not in practice	37·0	56·0
Abroad	16·5	13·0
	100·0	100·0

You will observe that the trends are very similar to those revealed by the Institute's figures, in particular the substantial increase in the proportion of members not in practice, no doubt reflecting the drift into industry.

From this brief survey, therefore, it is clear that the profession has grown vastly and its field of activity has expanded greatly, and in fact accountants are now playing a very important part in the economic life of the nation.

As to the future, whatever form the reorganization of our world may take, one thing appears to be quite certain, and that is that there will be an increasingly important part for accountants to play provided they are competent to assume these increased responsibilities.

The vital problem immediately facing us is therefore to make quite sure that we are fitted to assume our future responsibilities and particularly that our younger generation, with whom the future lies, is given an education and training that will enable it to develop to the full every possibility of rendering further service to the community.

The question of our educational system is therefore, in my opinion, of paramount importance and urgently needs the closest consideration of the governing bodies of the profession.

If any of you are interested in this subject I would strongly recommend you to read *The Professions* by Messrs. Carr-Saunders and Wilson, and to compare our system of education with those of the medical, solicitors and engineering professions.

You will see that the universities play a very important part in the systems of education of these professions, whereas they play no part whatever in ours.

It is interesting to recall that originally the educational system of the medical profession was based upon the apprentice system, but that practice has long since been entirely discarded. The teaching now is in the hands of the hospital schools and the medical schools at the universities. Furthermore the British Medical Association has special committees devoted to the investigation of medical problems and it expends considerable sums upon the promotion of research.

In the case of solicitors, their students must attend courses of legal education approved by the Law Society and most of the universities and university colleges have such approved schools.

In the case of engineering, academic training is an essential part of their system of education. In Scotland every accountancy apprentice for many years has been required to attend law classes at a university and since the 1914–18 war they have also been required to attend university classes in accounting and business methods.

In the United States of America, as no doubt you are aware, the whole of the education of the accountancy profession is in the hands of the universities.

In dealing with our educational system in *The Professions*, the

authors state—"The universities play no part in the scheme except that graduates are exempted from two years' articles, and the dearth of proper places of instruction makes the accountancy profession the happy hunting ground of coaching institutions. Of these some are conducted under the auspices of the students' societies and a few by local education authorities; but the majority are purely private venture establishments." In an article in *The Accountant* as long ago as 1926, it was stated—"*Under American practice the State Universities* regulate the practice of professions. That arrangement is never likely to become the rule in this country. Just as the British Universities are the nurseries of the bar and of medicine, so might their organization be turned to account in the preliminary training of embryo accountants . . . Cannot some arrangement be made between the Institute and Society on the one hand and the Universities on the other for the elaboration of a mutually satisfactory curriculum?"

As you all know only too well, our educational system is mainly based upon correspondence courses, and practically the whole of the student's theoretical study has to be done at night after a full day's practical work. I am certain that no authority on education would agree that this can be a satisfactory system for any profession.

Were our educational system raised to university level there is no doubt, in my mind, that it would be vastly improved but other great advantages would follow. If, as with the older professions, some of the best brains of the younger generation were attracted to teaching at university schools of accounting, we should at last commence to build up our literature. Up to date the textbooks produced by the profession are chiefly confined to the needs of examination students and there are very few that have advanced materially our professional knowledge. The need for better advanced textbooks for practitioners is, in my opinion, most pressing.

A further advantage of paramount importance would be that these schools would be in a position to undertake research work for the profession. For this, I have always felt, there is a crying need. There are so many important problems that require thinking out, but we have no time for this, as we are all so pressed with our day-to-day affairs, as are the practitioners of all professions. It is for this obvious reason that the older professions have developed research work by trained workers upon a full-time basis. Only upon these lines is real progress possible. This is a vital problem that, it seems to me, requires the serious consideration of the profession. The older professions have all arranged for a "thinking department" staffed by academically trained staff, but we have not made any similar provision.

We have been described as "the medical consultants of industry" but do we know enough of the industrial body, of its ailments and their cure, in order to give sound advice? The medical profession directs great efforts towards studying the human body in every possible way,

this work being undertaken by research workers for the benefit of practitioners, but we have no organization upon these lines. Each practitioner is left to experiment on the industrial body by the trial and error process as originally did the medical practitioner on the unfortunate human body.

I appreciate that important steps in this direction have been taken by the Institute and the Society, the former by the inauguration of the Taxation and Financial Relations Committee and the latter by the creation of its Research Committee. I am confident that these committees will do invaluable work for the profession, but as these committees are composed of very busy accountants meeting only for a few hours from time to time, there is a definite limit to what they can achieve and progress must be very slow. What I have in mind, therefore, is full-time research by specially selected personnel.

I am sure you will agree that there is every indication that there are many further responsibilities awaiting the profession in the future in the industrial field, but only if we are fitted to undertake them. We must therefore study the industrial body in minute detail; a thorough knowledge of accounting is but a small part of this problem. As matters stand at present where can our practitioners and students learn anything about the wide range of industrial subjects? But if the rising generation is to undertake these responsibilities they must be instructed in them as they are in accounting subjects.

I now propose that we should look back to mark the progress and position regarding the specialized technique of our profession. Some progress there has been, particularly in the form of presentation of the accounts of companies, a subject which the Taxation and Financial Relations Committee is at present considering.

In connection with the technique of our profession, the striking fact is that there are such wide differences between the opinions and practice of individual accountants. This, I suggest, is a serious weakness that requires the closest consideration. These differences of opinion and practice are not perhaps surprising as the profession has developed upon purely individualistic lines as there has not been in the past any attempt to establish accepted and collective opinions.

The following are a few matters that occur to me upon which opinions differ and I am giving them, not to start a discussion upon them, but in order to illustrate the types of problem that require thinking out and in regard to which a "thinking department" could render invaluable aid.

Secret Reserves

An event that had a most profound effect upon our profession was, you will agree, the Royal Mail Steam Packet case, which completely changed the opinion of accountants regarding part of the difficult question of secret reserves. As a result of that case, so far as I can judge,

the accepted practice now is that if a company draws upon reserves created in the past, the auditor must insist upon this fact being disclosed, but the important point as to whether directors are entitled to create secret reserves is still undecided. I have seen the Balance Sheet of an important engineering company, with land, buildings, plant, machinery and equipment standing at £1. The auditors' report stated that this Balance Sheet showed a true and correct view of the state of the affairs of that company. Are we quite satisfied that this statement in the auditors' report was justified? There have been many voices outside the profession that have been raised against us upon this question of secret reserves.

Within the profession I think that we should find three opinions regarding the foregoing Balance Sheet. The first would be that as the directors clearly stated that the whole of these fixed assets were valued at £1, and as that figure was well below the true value, there was no need for the auditor to qualify his report. The second would be to the effect that the auditor should introduce a sentence in his report stating that, in his opinion, the true value of these assets was considerably in excess of the value stated in the Balance Sheet. The third, and I suggest minority view, would be that the Balance Sheet did not show a true and correct view of the state of affairs of the company, and that it was the duty of the directors to render a true and full account of their stewardship. The auditors should therefore have insisted upon a reasonable value being placed upon these assets, failing which they should have qualified their report. This important subject needs profound thought.

The Valuation of Inventories

The valuation of inventories is a matter of prime importance in the case of the majority of Balance Sheets and many different methods are adopted in practice. We have our old and time-honoured maxim that the basis should be the lower of cost or market value, but there is no accepted understanding as to what we mean by cost or what we mean by market value. We each have our own interpretation but the differences of practice are astonishing. This important problem urgently requires to be thought out anew, and also the whole question of the auditors' duties and responsibilities regarding thereto.

Depreciation

The methods adopted for writing off depreciation of fixed assets is another matter of great importance. According to our textbooks, there are some seven different methods of making the calculations. They all give different results and yet they are all claimed to be correct. As you know, in America there is only one method which is standard practice. Are we satisfied that our variety of methods is sound, and are we sure that the American views on this matter are wrong?

A basic factor upon which opinions differ, is as to whether depreciation is provided with a view to replacing out of profits the cost of an asset or to accumulate the estimated cost of replacement.

A further point in connection with depreciation upon which practice differs is its treatment in the Balance Sheet. In the majority of cases depreciation is deducted from the cost of the assets, but in others the total depreciation provided to date is shown in the other side of the Balance Sheet amongst reserves which represent undistributed profits. Some would contend that the latter practice is most misleading and undesirable, but it is often seen.

Balance Sheets and the Price Level

A most important problem that may arise after the war is whether the items in Balance Sheets will require revaluation if the price level moves by reason of inflation. This vital problem urgently requires thinking out for the benefit of industry and our profession.

Form of Accounts

The question of improvement in the form of presentation of the accounts of companies is under consideration by the Taxation and Financial Relations Committee. This reconsideration of this important subject is most welcome as the diversity of opinions involved is remarkable.

The Accounts of Holding Companies

The form of presentation of the accounts of holding companies is a complex problem that requires thinking out for the benefit of industry and the profession.

In the case of international holding companies a most complex and difficult question that requires solution is as to how exchange should be dealt with in the annual accounts. Another is how assets in enemy occupied and controlled countries should be treated in accounts.

Costing

Costing is becoming ever more important and I feel that our profession needs to study this problem far more closely and extensively than it has done up to date. There is no doubt that thorough research would be invaluable to practitioners and to industry. At present, opinions and practice vary greatly.

The foregoing are a few examples, selected at random, of the problems that require thinking out, and this would obviously be greatly facilitated if there were scientific experts available to whom these matters could be referred for investigation and report. Such reports would, of course, be presented to the governing bodies of the profession for final decision and in this way collective and accepted principles and practice would be established.

Individually we are all far too pressed by our day-to-day responsibilities to find the time to solve these complicated problems. If we were to set up a "thinking department" on a full-time basis, we should be merely following the example of the older professions and I find it difficult to convince myself that our profession is so different from the older professions that we do not require the scientific thought and education that they do.

There are those who urge that audits of the future should include management as well as a financial audit. Were this to be the case our whole educational system would need further drastic revision and part of our training should be within industry, as in my opinion it is not possible to learn management by theoretical study outside industry. It may be that in the future management audits will be introduced, but if so then in my opinion such audits should be carried out by specially trained staff all of whom should have gained considerable experience within industry. Personally, I do not think that management audits could be effectively carried out by accountants.

For the foregoing reasons I suggest that accountants should study the problems of management as this knowledge will enable them to render invaluable service to industry. As the medical consultants of industry we cannot learn too much about the body of our patient.

I will now, with your permission, attempt to summarize these random thoughts.

(*a*) In the future, I imagine that accountants will play an increasingly important part in connection with the direction and management of industry, but if this is correct then the future members of our profession will need a much broader education and training than past generations have had.

(*b*) Accountants in increasing numbers will, I think, drift into full-time employment in industry and commerce. I suggest, therefore, that our governing bodies would be well advised to consider their policy regarding this development. The following are a few of the points requiring consideration—

1. Is this drift into industry a good thing for the profession, or not?
2. Should it be encouraged?
3. Should accountants who take up employment in industry be regarded as having "left the profession?"
4. Should not close co-operation between accountants in industry and practice be fostered and developed so far as it is possible upon the basis that they represent two sections of one profession, the one section being the complement of the other?
5. Should not our system of education be broadened with a view to giving all of our students a working knowledge of the management field?

6. Should not accountants in industry have a voice in the councils of the profession? Might not this be beneficial both to practitioners and accountants in industry?

(*c*) It would seem to me most desirable that the question of registration for the profession should be reconsidered.

(*d*) I would strongly urge that our whole system of education needs reconsideration, and I would venture to suggest that a special committee of the Institute and Society should be appointed to consider this matter in consultation with the older professions and with recognized educational authorities.

(*e*) I would also urge that the above committee, if appointed, should also consider the provision of facilities for the carrying out of full-time scientific research work for the benefit of the profession as a whole.

(*f*) I would also suggest that this committee, if appointed, should consider whether it is possible to encourage the provision of advanced textbooks for the benefit of practitioners and accountants in industry.

(*g*) It would seem most desirable that the present attempt to build up a code of accepted accounting principles should be developed so far as is possible for the benefit of the profession and that accountants should use their influence towards improving the form of presentation of accounts. The extraordinary diversity of opinions and practice of individual accountants is, I suggest, the weakest point in the present position of the profession.

(*h*) Uniformity in accounting is impossible unless and until agreed principles have been established for the measurement of industrial income. This is a matter of the greatest importance and goes to the roots of true accounting. The present position, I submit, is extremely unsatisfactory owing to the diversity of opinions and practice regarding this fundamental matter.

(*j*) In this country the almost universal practice is for companies to publish what is, in effect, merely an Appropriation Account. A decision is required as to whether the boards of companies should not be required to publish a reasonable summary of their Trading and Profit and Loss Accounts as is the practice in America.

(*k*) A revision of the Companies Act, I suggest, is long overdue. It would seem to be prudent, therefore, for the profession to commence consideration of what its recommendations are to be when the Act is in course of revision. In this connection, the following is an extract from the City Notes in *The Times* of the 8th March, 1943.

"It has been said that professional organizations always tend to wait upon the law and upon public opinion to lay down for them the principles which should govern their professional practises; that instead of leading the way in the formulation of desirable reforms, they allow themselves to be

led. This no doubt is a gross libel. But there is enough truth in it to make it worth while for those professional bodies which are concerned with company affairs to start making up their minds and expressing their considered views about a number of such matters. They could thus pave the way for the next amendment of the Companies Acts."

There is, I suggest, in the above quotation much food for thought.

In conclusion may I say that I hope that none of you will regard me as a destructive critic of our great profession. On the contrary, it is because I am so proud to be a humble member of it, that I am so anxious that we shall play an increasingly important part in the affairs of our country in the most difficult times that lie ahead. In order to achieve this object it would seem necessary that we should take stock of our present position and carefully prepare so that as the opportunities arise we may be enabled to render the maximum service to the community. In this way the high reputation already built up by the profession will be greatly enhanced.

Chapter XVIII

Education for the Accountancy Profession

Letters to "The Accountant."

I HAVE read with considerable interest "Inkey's" letter in your issue of the 11th inst., and in my opinion the present system of education is far from satisfactory.

The practical work of the average articled clerk is mainly devoted to routine checking, which is of little educational value, and the theoretical studies of the great proportion of students are conducted by the professional "crammers." No doubt the results are satisfactory from an examination point of view, but from the point of view of the education of the future members of a great profession the present position, in my opinion, is capable of considerable improvement.

I do not think that any change can be effected until the Councils of the Institute and the Society take a direct interest and concern in the methods of education of their future members.

Considerable progress in the study of accountancy has been made in recent years by the modern universities, and I would suggest that the accountancy profession should take an active interest in this work, as, for example, the legal profession does in the faculty of law.

Those who appreciate the great possibilities for the future development of accountancy, realize that there is a real need in this, as in other branches of human effort, for sustained academic study and research. The commercial world has realized the value and possibilities of this work and the developments to date have been initiated and financed to a considerable extent by such men as the late Sir Ernest Cassel; but so far as I am aware, the Institute and the Society have not directly concerned themselves with the academic study of accountancy or research work, and apart from the setting of examinations and financial support given to Students' Societies, they have not concerned themselves directly with the educational methods in force within the profession itself.

22nd December, 1926.

The Training of the Articled Clerk

The subject of the training of articled clerks, which is raised in the leading article, and Mr. Gardner's address in your issue of the 17th inst., is one of paramount importance and interest to all who have the future of our profession at heart.

It is nearly fifty years since the Institute was founded and the system of apprenticeship for prospective members was instituted. Since then the profession has developed enormously and the responsibilities of a chartered accountant to-day are far greater than was ever anticipated in those early days. The work of the profession is ever widening and in my opinion there are still further responsibilities ahead if the members of the Institute are fitted to undertake them.

It appears to me, therefore, that the vital question of professional education should be reconsidered and I would suggest that the Council should appoint a committee to investigate this matter and make recommendations.

Having been connected with professional education for the past twenty years I have had an opportunity to study closely the working of the present system of education, and I am firmly of opinion that it does not meet the present and future needs of the profession as I visualize them.

Education for all professions must be based upon the study of practice and theory. As regards practical work, the principal binds himself to afford his articled clerk "such reasonable opportunities and work as may be required to enable him to acquire the art, science and knowledge of a professional accountant." We employ our articled clerks upon routine work, but years of checking postings, castings, vouchers, pass books, etc., and looking for differences in trial balances, *do not enable them to become masters of their profession.*

The principal is fully occupied with his professional work and cannot find the time to educate his pupil, but I think that articled clerks should be given greater opportunities of learning their profession from the principal's point of view.

With regard to theoretical training, the articled clerk is expected to devote the whole of each working day to his practical work and to find time out of office hours for his theoretical studies, with perhaps a few weeks just prior to the examinations. In the majority of cases the theoretical training consists mainly of six or nine months' evening course with a professional "crammer."

In my opinion the opportunities and the facilities available for education are quite inadequate for the future members of our great profession. I suggest that the experience and methods of the other great professions should be studied. In the medical profession the apprentice system was discarded, I think, about 100 years ago, and the basis of education is the interweaving of practical work with theoretical study. On the theoretical side the universities play a most important part, as they do also in the cases of law and engineering.

In my opinion our professional education requires to be raised to a university level and I would suggest that departments of accountancy should be endowed at the universities, such departments covering the whole range of subjects required by our students.

If this were done I would suggest that the five years of training should be apportiontioned as follows—

First six months—Whole time courses at university.

One year—Practical work with firm of chartered accountants.

One year—Whole time courses at university leading up to intermediate examination.

One and a half years—Practical work with firm of chartered accountants.

One year—Whole time courses at university leading up to final examination.

Such a system would afford a course of real education upon the broadest lines and would, in my opinion, meet the present and future needs of the profession.

In the other professions the universities, apart from their educational work, make great contributions to the profession itself, and I am confident that a university study of the principles and technique of our profession might well have far-reaching results.

I must apologize for the length of this letter; my excuse is the great importance of the subject, which, it appears to me, urgently requires the careful consideration of the whole profession.

20th November, 1928.

Education for Commerce

I have read with interest your leading article upon Education for Commerce appearing in your issue of the 31st ult., and in particular your references to the education of articled clerks.

I am pleased to note that you favour the suggestion I made in 1928 that the education of articled clerks should be based upon a combination of articled service and university training. For many years I took part in the education of accountancy students and I have therefore had an opportunity of studying closely the present system of education which I am firmly of opinion is very far from satisfactory.

From the point of view of the practising member, the supply of cheap labour is no doubt attractive, but in my view the increasing responsibilities of the profession are such that the education of its future members should be upon a much broader basis than it is at present. Our profession, I suggest, would be well advised to study the systems of education adopted by the older professions, such as medicine, which are based upon the interleaving of practical and theoretical work. For this purpose obviously the student's available time must be apportioned. At present nearly the whole of a student's working days are devoted to practical work and he or she is expected to do his or her theoretical work out of office hours. This system, in my opinion, fails to recognize the great value and importance of a scientific study of the whole field of accountancy.

I would further suggest that the Institute should take a direct interest in the teaching of accountancy at the modern universities. So far as I am aware, up to date it has not done so.

In the University of London there was a chair of accountancy tenable at the London School of Economics and which was first occupied with great distinction by my friend the late Professor Dicksee. I succeeded him, but when I retired at the end of 1929 this chair was utilized for another purpose and therefore there is no such chair of accountancy.

I would urge, as a matter of vital importance, that the profession should carefully consider the whole question of the education of its future members and also the desirability of the Institute taking a direct interest in the teaching of accountancy at the modern universities. Were the Institute to utilize part of its funds in the endowment of chairs of accountancy it would, in my opinion, not only be of great value to accountancy students but to the profession as a whole.

At the present time there are many important questions upon which, collectively, the profession has not made up its mind, and following the experience of the older professions, great benefits should accrue from the setting up of a scientific side to our profession.

2nd January, 1933.

Education for the Profession

I have read with great interest the leading article which appeared in your issue of the 19th inst., and in which you review a book on *The Professions* by A. M. Carr-Saunders and P. A. Wilson.

I have not yet read the book, but from your review I gather that the authors severely criticize our tutelage system, the premium system, and the fact that universities play no part in the scheme of education of accountancy students with the consequence that our profession has become "the happy hunting ground of coaching institutions."

With these criticisms I am in entire agreement. In 1928 in your journal I suggested that the education of accountancy students should be based upon a combination of service with a practitioner and university training. In January, 1933, I again referred to this same subject and suggested that "the Institute should take a direct interest in the teaching of accountancy at the modern universities." I further pointed out that whereas there was a chair of accountancy in the University of London, that chair had been discontinued, but this fact, so far as I can judge, has passed unnoticed by the profession.

I am firmly of opinion that the present system of education is far from satisfactory from several points of view, and that it should be founded upon a much broader basis.

Further, it appears to me that up to date the system of education has been directed solely towards the production of practitioners. An

increasing number of our members, however, are absorbed by industry, but our present scheme of education does not by any means cover all the requirements of industry. Accountants employed in industry have a valuable contribution to make, and this factor I suggest deserves the serious consideration of the profession.

Were the profession to encourage and develop the teaching of accountancy at the universities it would represent the setting up of a scientific side to the profession such as obtains in the older professions. Up to date we have done little in this important direction, and in consequence have produced very few writers who have made substantial contributions to the knowledge of the profession—of students' "cram" books there are many.

In my view these circumstances partly account for the fact that as a profession we have not established our principles upon many important and fundamental matters of accountancy, such as secret reserves; the basis upon which the accounts of holding companies should be prepared, how the profits and losses of subsidiary and sub-subsidiary companies should be dealt with in the accounts of the holding company, what information should be disclosed in the published Profit and Loss Accounts of companies, the basis of calculation of depreciation of fixed assets, the basis of valuation of stock-in-trade and how forward contracts should be dealt with in accounts.

Upon these matters we all have our individual opinons, but it seems to me that collectively the profession has not made up its mind. I suggest, therefore, that we should endeavour to do so, and that we should aim at uniformity of practice based upon generally accepted principles.

I must apologize for the length of this letter, my only excuse is that I feel most strongly that our profession has reached a stage in its development when its scheme of education requires thorough reconsideration and, further, that every effort should be directed towards establishing our fundamental principles.

30th August, 1933.

Chapter XIX

The Detection of Frauds in Accounts

A paper delivered before the Birmingham Chartered Accountant Students' Society, on 21st October, 1920, the London Chartered Accountant Students' Society on 27th October, 1920, the Bristol Chartered Accountant Students' Society on 8th December, 1920, and the Leeds Chartered Accountant Students' Association on 17th February, 1921.

ONE of the main objects of an audit is the detection of fraud, and the successful attainment of this object involves a task of great difficulty, calling for the exercise of considerable skill and experience on the part of the auditor and his staff. The persons responsible for the fraud are inside the business, and in a concern of any magnitude there may be opportunities for concealing the defalcations, thus making detection a matter of great difficulty, in view of the fact that the books of account necessarily contain a vast number of detail entries.

The mere routine checking of an audit will only disclose clerical errors and simple frauds, but will seldom reveal one that has been skilfully concealed. In order to discover these, an auditor must go behind the actual books of account, and examine original records and make intelligent inquiries; in fact, he must go to the foundations upon which the books of account have been built up.

In practice, there is a considerable danger of the periodical audit becoming mechanical, and in consequence drifting into being a matter of lifeless routine. Especially where the auditor undertakes the balancing of the books is this the case, as it may be that the routine checking necessary in connection with the balancing involves the expenditure of considerable time and effort. In such circumstances, having completed the trial balance, the audit staff may feel that their labours are over, but, in fact, very little real audit work will have been carried out at all.

There is a tendency, in my opinion, for too great a proportion of the time of the audit staff to be devoted to what may be described as "tick-work," whereas a proportion of such time could be expended far more effectively in testing the entries in the books of account, with original records, etc. For example, to check the whole of the sales ledger postings may take a considerable time, but in most cases only clerical errors will be revealed as the result of these labours, and nothing will have been done in order to ascertain that all sales have been included in the sales day book; that no fictitious sales have been entered; that all the cash paid by debtors has been accounted for, and that all the credits to sales ledger accounts, such as returns, allowances, discounts, bad debts, etc., are genuine entries.

In the case of a clever fraud, as a rule, the actual entries in the books will be found to be in apparently perfect order, the defalcations being concealed by the omission of records from the books of account, or by the making of fictitious entries. If the auditor works to a stereotyped programme, in course of time the staff of the concern whose books are under audit must become aware of the books, vouchers, etc., which the auditor calls for, and the general details of his programme of work. In such circumstances, if there are any loopholes in the plan of the audit, these can be taken advantage of. It is, therefore, of the utmost importance that you students should appreciate the dangers that lie in front of the careless auditor, and how essential it is that an audit must be based upon a careful and well-thought-out plan, which from time to time should be varied as much as possible, and brought up to date. To carry on from year to year upon exactly the same lines may be to court disaster, and an auditor who has failed to detect fraud, and who has not taken all reasonable precautions, may become involved in a claim for heavy damages, and in any event his prestige must suffer greatly.

The auditor must base his investigations upon the system of bookkeeping, organization, and internal checks in force in the particular business. When considering the whole system, the auditor's experience will tell him where the organization is weak, and where there are possibilities of fraud; in these directions he will take special precautions, whereas in cases where the internal check is strong, he will confine himself to tests.

If the audit is to be successful it must be based upon a well considered plan, arrived at after a careful study of all the circumstances. This requires great skill and experience, and upon this the efficiency of the audit will depend.

When carrying out the work of the audit the staff engaged should be constantly alert, as in many cases the original discrepancy, which has opened up an extensive fraud, has been a small and insignificant item. If the auditor is not a man of character and experience, it is very easy for him to be put off by plausible explanations at this initial stage. If the defrauding party is clever, the defalcation will be skilfully concealed, and he will have ready explanations for any inquiries raised. In my experience, frauds in many cases are discovered, not in the first case by conclusive evidence gathered from the books, etc., but by the auditor's judgment of character and evidence. It may be that an inquiry is made, but for reasons that it is difficult to account for, the auditor is dissatisfied with the explanations given, and although he has no real grounds for suspicion, he pursues his inquiries and investigations on the particular point relentlessly, with the result that serious defalcations are revealed. I have had cases in my experience where, although exhaustive investigations had been carried out, no actual discrepancy could be traced, or only a few doubtful cases were revealed, and in

respect of which apparently good explanations were forthcoming, but in the end, by absolute "bluff," a confession has been obtained from the delinquent. In such cases, the auditor could not explain why he was not satisfied with the original explanations; it is merely that the general attitude of the official concerned and the explanations given, somehow have not rung true. Where for any reason suspicion, however slight, has been aroused, an auditor must probe the matter to the end.

As stated above, the scheme of the audit must be based upon a careful study of the book-keeping system and internal checks in force, and in making these inquiries the auditor should trace the organization back to the very commencement. For example, when dealing with cash receipts, he should ascertain, amongst others, the following facts—

(*a*) In the case of receipts by post—

1. Who opens the correspondence?
2. How are the receipts then dealt with?
3. Who is responsible for making out and sending the receipts to payers?
4. Who makes up the paying-in-book?
5. Who pays in to the bank?
6. Who is responsible for keeping the cash book?
7. Who is responsible for keeping the ledgers?
8. Who is responsible for sending out the monthly statements to debtors?

(*b*) What is the system as regards cash sales?

(*c*) In the case of cash collected by travellers, etc.—

1. What records are kept, and what is the system?
2. Who gives the receipts?
3. What checks are in force?

Before passing to a more detailed consideration of our subject, I would especially impress upon you the dangers and difficulties that arise in the case of a "one man business" that is to say, in a small concern where one man is in entire charge of the whole accounting system, working with perhaps one or two juniors to assist him. In such a case, this man is acting as cashier, ledger keeper, wages clerk, and deals with the correspondence, the sending out of receipts, invoices and statements, etc. In such circumstances there is no form of internal check, and, therefore, it is impossible to prevent fraud if this man is dishonest. Far greater precautions, therefore, must be taken by the auditor, and although it may be impossible, without luck, to detect fraud in its initial stage, yet the audit should reveal extensive frauds carried on for a lengthy period; but the danger of these circumstances must be borne in mind by the auditor. In consequence, he should vary his programme, make it as exhaustive as possible, and follow up closely all doubtful points and queries.

The position in the case of a large business where an efficient internal check is in force is totally dissimilar, as the system can be so organized that the various sections of the staff of the business are acting as a check upon other sections. For example, the cashier should have no control over the ledgers or the sending out of invoices and statements. In these circumstances, it is far more difficult for defalcations on a large scale to be concealed, and collusion in cases of fraud is not common. The auditor, therefore, is relieved of a considerable amount of detail work, and may rely upon the internal checks, applying tests, and confining his main efforts to the weak and essential points.

I now propose to give examples of likely forms of fraud, and to outline the steps which an auditor should take in order to discover them, but I wish to make it quite clear to you at the outset that I do not suggest that all the detail precautions given must be taken in the course of every audit. The auditor's programme in the case of each audit depends upon the whole of the circumstances of the particular case, and it is his reponsibility to decide upon the scope of his investigations, but naturally in cases of suspicion his audit will be far more exhaustive than in those where there is no sign of malpractice.

What you students must study carefully is the possibilities of fraud and the precautions to be taken in order to counteract them; also the necessity for the variation of the routine of an audit, and the importance which attaches to the laying down of the original plans of the audit. In practice, you must avoid becoming mechanical and submerged in the detail checking, but you must constantly bear in mind that in the majority of cases fraud will only be detected by digging under the surface of the accounting system. In studying this complex subject, and in actual practice, imagination is an asset of the greatest value. When engaged upon your professional work, although in a junior capacity, think out the possibilities of fraud in connection with the particular work upon which you are engaged, and how far the checks that you are applying, and the method with which you are carrying them out, may be relied upon to reveal any discrepancies. I heard of a case recently where a man purchased a business, the accounts of which had been audited, but he subsequently discovered that the greater part of the records, vouchers, etc., were dummies, the books having been specially written up in order to effect the sale of the business. At first sight it would appear to be impossible for an auditor to be hoodwinked in this way, but in fact it is far more easy, if the audit is carelessly carried out, than would appear to the uninitiated.

If you approach your work in the spirit that I have suggested, it is certain that you will find that practical auditing is full of interest, and you will master your profession rapidly, and to a degree that you can attain in no other way. On the other hand, if you perform your work mechanically, and without the exercise of imagination, your tasks will inevitably become wearisome and uninteresting, with the

result that the possibilities of your failing to detect fraud are very great indeed.

Fraud may be classified under the following two heads—

1. The misappropriation of cash or goods.
2. The falsification of the accounts unaccompanied by misappropriation.

As regards cash misappropriation, the fraud will be effected either by omitting cash receipts from the books of account, or by entering fictitious payments. In the first case, these defalcations can be discovered only by checking the book entries with original records such as till-books, salesmen's books, cash diaries, counterfoil receipt books, agents' returns, etc. In the case of fictitious payments, these should be detected by an examination of vouchers, invoices, wages sheets, and other direct evidence of this nature, but it is comparatively simple to prepare a bogus voucher. For example, imagine the case of a business where, say, £20 is owed to H. Henderson & Co., this amount having been properly passed through the books and in due course paid. Subsequently, this amount is duplicated and again passed through the bought books, and a second cheque is put forward and signed. This cheque is then misappropriated, it is entered in the cash book and posted to H. Henderson & Co.'s account, thus balancing the fictitious entry on the credit side. In order to provide a voucher for the fictitious item, the invoice or statement received from Henderson & Co., for the original amount, is taken, stamped and receipted. Imagining these circumstances, I wonder how many of us in this room would, when vouching for that month, fail to imprint our audit stamp upon that bogus receipt? I can picture the two audit clerks, one with the cash book, a pen, and a pot full of violet ink, the other with the bundle of vouchers. The clerk with the cash book calls out "Henderson & Co., £20," and with a dull thud the audit stamp falls upon the bogus receipt, and a neat little "V" is placed against the item in the cash book, accompanied by a smile from the defaulting cashier in the background. But no doubt none of you would in practice be caught by such a simple trap as this, even though the day had been long and wearisome, and the time was 4.50 p.m.!

Misappropriation of goods is even more difficult to discover than misappropriation of cash, unless accurate stock records have been kept. In fact, without such records, it is almost impossible to detect small defalcations. Misappropriation, however, on a large scale would affect the percentage of gross profits to sales, and may thus be indicated, and in some cases it is possible to compile quantity accounts which would reveal the discrepancy.

The falsification of accounts, unaccompanied by misappropriation, may be very difficult to discover; in these cases the defrauding party probably will be a responsible official such as a manager, director or,

partner, and the object may be to bolster up the concern with a view to obtaining credit, or further capital, disposing of the business, disposing of the shares of the dishonest officer, or with a view to increasing commissions on profits payable to him by the company.

Such falsification may be effected by over-valuation of stock-in-trade and other assets; insufficient provisions for bad and doubtful debts and depreciation, or the suppression of liabilities. In the ordinary way, an auditor must depend to a certain extent upon the technical knowledge and the judgment of the responsible officials of the business as regards the valuation of assets, etc., and, therefore, if the information is deliberately false, he is faced with an extremely difficult problem. The auditor's only means of detecting this class of fraud is a scientific audit skilfully carried out. His investigations must be thorough, and his judgment good. If he is of the opinion that the profits are overstated, in spite of all the arguments put forward by the officials, he must have the courage of his convictions, and make an adverse report, whatever the immediate consequences may be to himself. This requires courage, but in the long run it is far better to lose one appointment than to mar one's professional reputation, and perhaps, in addition, have to pay heavy damages when subsequently it is proved that the accounts are false.

For the purpose of illustration, I propose taking a few examples and considering these in detail.

Credit Sales

In this case the fraud may take the form of omitting individual sales altogether from the sales day book, the cash subsequently paid by the customer being misappropriated. Another line of action lies in the misappropriation of cash received from customers, although their accounts have been debited with the goods. In course of time this latter type of fraud must come to light, owing to the heavy increase in the book debts, but to a certain extent such defalcations may be covered by making fictitious credits in the ledger accounts in the way of returns, allowances, bad debts, etc. Again, suppose a case where £50 paid by customer "A" has been misappropriated, and customer "B" subsequently pays his account of £100. In the cash book the £100 may be entered as "A" £50 and "B" £50, and thus "A's" account is balanced, and the defalcation is transferred to "B's" account, which is a more recent one, and is less likely to attract attention.

Misappropriation may again be effected by means of fictitious discounts; for example, customer "C" remits a cheque for £50 in settlement of his account for that amount. This is entered in the cash book as "Cash £47 10s. and Discount £2 10s.," the £2 10s. being taken out of cash receipts when same are banked.

It will be observed that the ordinary routine checking of the sales day books and ledgers will not reveal any of the foregoing types of

fraud, which can only be discovered by checking the books with original records, if these are available.

The omission of sales and fictitious sales may be detected by comparing the sales day book entries with such records as order books, press copy invoices, travellers' returns, goods outwards books, etc.

Misappropriation of the cash received from customers may be revealed by checking the cash book entries with rough cash book or cash diaries, if such records have been kept. The checking of the cash book entries with counterfoil receipt books may reveal the fraud, but the counterfoils may be easily manipulated, so that, except on the first occasion, it is improbable that this test will disclose the fraud. I have, however, had several cases in my own experience where this check has proved successful. In this connection, it is of great importance, from an organization point of view, that unused receipt books should be kept under proper control. In a recent case, I found that the defaulting cashier kept a separate receipt book for giving receipts in cases where he was misappropriating the cash received.

The splitting of cheques and fictitious discounts may be traced by comparing the cash book entries with the counterfoils, or, better still, the original paying-in slips.

In cases where fraud is suspected, the simplest method of procedure is for the auditor to send direct or supervise the sending of statements to all debtors on the sales ledgers. If, therefore, cash has not been accounted for, the balance will not agree with the customers' books, and this the debtor will point out.

The returns and allowances books may be checked with press copy credit notes, goods inwards books, and correspondence, with a view to ascertaining that all the entries are genuine.

Bad debts written off should be examined in detail with a responsible official, and any doubtful cases followed up.

In the case of a business of any size it is possible to organize a system of internal check which will make all the foregoing classes of fraud very difficult to effect without collusion. The ledgers, books of first entry, and the sending out of receipts, invoices, and statements, should be under separate control, and divorced entirely from the cashier's department; therefore, the persons handling the cash have no means of making false entries in the ledgers and other books, and if cash is not accounted for, a statement will be sent to the customer, on which he will not be given credit for the cash paid. In the same way—as the sales day book clerks have no control over cash—there is no inducement to them to omit sales and make false entries

Before passing from the subject of credit sales there is the question of the provision for bad debts, which in a business where the book debts amount to a considerable sum is an important point, as the trading results can be improperly inflated by an insufficient reserve under this head. In a recent case (*Arthur Green & Co.*, v. *Central Advance &*

Discount Corporation) the auditors were held to have failed in the discharge of their duties, in that they did not report that the book debts shown in the Balance Sheet were considerably over-valued.

By a careful study of the accounts in the sales ledgers, an auditor of experience is in a position to judge, with some degree of certainty, whether the reserve is adequate. When examining individual accounts he should note the age of the debt, how the balance shown on the account is made up, whether bills and cheques have been dishonoured, whether small payments only on account are made, and the balance on the account over a period is increasing, whether the debt is statute-barred, whether there are any notes on the account, such as "In Bankruptcy," "In Liquidation," "In Solicitor's hands," "Account stopped," "Left no address," etc. After this examination, the auditor should go through all the doubtful accounts with a responsible official. Although the auditor cannot possibly have any personal knowledge as regards the financial standing of these individual debtors, yet an auditor of experience is not easily misled as to what, approximately, is a sufficient reserve.

Cash Sales

In this case the system of internal check is all important, as if the system is bad, or there is no system at all, it is practically impossible to prevent or detect leakages. The basis of every reliable system is that the salesmen shall not receive the cash; this you will find in any well organized shop. Upon the sale of the goods, the salesman makes out and hands to the customer a bill, which the customer then presents to the desk cashier, with the cash. In this way, the summaries of the salesmen's books are a check upon the desk cashier's takings, and both records are available to the auditor as a check against the amount of the cash sales banked. In smaller businesses, automatic tills are used commonly, although this is by no means so efficient a system; in this case, the cash sales accounted for can be tested with the automatic till records.

If there is no proper system, then all the auditor can do is to test the cash sales with whatever original records are available, but in such cases very little can be done, and the auditor should report to this effect to his client. A loose system means putting temptation before the employees, and is unjustifiable upon that ground alone.

Purchases

The possibilities of fraud as regards purchases are, the omission of purchases in order to inflate the profits; the payment of accounts, the goods in respect of which have not been received by the business; the passing of the private accounts of officials through the books of the business; the duplication of invoices and the charging of revenue items to capital accounts in order to inflate profits, or vice versa. If the system is loose, these frauds are by no means easy to detect.

of the wages and the preparation of the wages book. In the case of time-workers, the best base is the time recording clock, whereby the time worked by each employee is automatically kept, thus eliminating disputes with the employees themselves, and providing the data from which the wages book is prepared. In the wages office, the weekly wages sheets are compiled from the clock records, the rates, deductions, calculations, and castings being made and the whole of this work being independently checked. Upon completion, the wages book should be passed to the cashier's department, when a cheque for the total wages is drawn, and the amount payable to each employee is counted out. Thereafter, to complete the system, the actual payment of the workers should be made by officials who have had nothing whatever to do with either the preparation of the records or the cash handling, and the payments should be made in the presence of officials, such as foremen, who are in a position to identify the workers. In effect, the system should be in the form of a circle, that is to say, the staff responsible for the work at any one stage should not be responsible for any part of the work at a further stage. For example; if a foreman controls the time or piece-work records of the workers under him, and upon the completion of the wages is handed the cash to pay his men, the system has broken down, as this foreman may falsify his records, and as he pays the men, fraud is simple.

In the case of piece-work, the system should be based upon records of the work performed, and if possible, the original record should be signed by the worker and the piece-work viewer. Subsequently, the procedure is the same as in the case of time-workers. As already stated, if there is no efficient system, the detection of fraud is very difficult. All the auditor can do is to test the wages drawn with whatever records are available. If, however, a proper internal check is in force, he can test the wages book totals with the amount of the cheques drawn. The main thing is to satisfy himself that the system is sound, and that it is, in fact, carried out.

If part of the wages bill is being charged to capital accounts, upon the grounds that it is in connection with the acquisition of fixed assets, careful inquiry and investigation should be made with a view to the auditor satisfying himself that these are proper charges to capital, and that only actual cost has been charged, no additions in the shape of profit having been made. The detailed analysis of the wages should be tested, and a certificate obtained from the responsible official. If large sums are involved, the accounts may be easily falsified by an improper analysis; the auditor must, therefore, carefully investigate the whole of the facts.

Cash Book

I have already dealt with a large proportion of the cash book entries, but dealing with the cashier's department generally, the whole system

requires most careful consideration. Any looseness in the organization may lead to fraud, and, therefore, to any weak points the auditor must pay special attention.

In the first place, in order to ascertain that the cash book is genuine, and in agreement with the books of the bank, the cash book must be checked with the bank pass book, and a certificate obtained direct from the bank to verify that the pass book produced is the original one; bogus pass books have been produced in cases of fraud. When checking the receipts side, the dates should be noted, as a simple fraud may be perpetrated by delaying the banking of receipts, the defaulting cashier making use of these funds during the period. This fraud may be detected with greater certainty by testing the cash book with original entries, such as counterfoil receipt books, cash diaries, etc. When checking the payments side, it should be seen that the names, dates, etc., in the cash book and pass book correspond.

As regards vouching, the sales ledger cash has already been dealt with, and miscellaneous receipts, such as amounts received upon the sale of assets, capital subscribed, rents, interest, commissions, etc., received, must all be vouched by the inspection of original records, in order that the auditor may satisfy himself that all receipts have been accounted for. It is most important that you students should realize that, when dealing with receipts, the point is not what is in the books, but what has been left out, and to detect omission requires great care and skill.

Recently I heard of a case where certain commissions to which a company was entitled had been misappropriated for years by the directors. In such circumstances it is extremely difficult for an auditor to detect the fraud, and this can only be accomplished if the auditor keeps his "eyes very wide open," and makes intelligent inquiries and investigations.

As regards payments, the possibilities are the inclusion of fictitious items, and, therefore, the whole of the payments must be vouched with receipts, invoices and other evidence in support of the same.

When vouching, care must be taken to see that the receipts and invoices, etc., are made out to the auditor's client; that the dates correspond, and that the items appear to be proper business expenses; any doubtful cases should be carefully inquired into. If vouching is carried out carelessly, it is very unlikely that fraud will be detected, and therefore in this, as in all his work, an auditor must be constantly vigilant. You will, I am sure, appreciate, for example, how easy it is to fail to detect that a particular payment refers to a previous year, and was improperly suppressed in that year in order to inflate the profits; that back receipts are produced in support of a fraudulent payment in a succeeding year, or that the receipt in question is for the private account of an official of the concern.

In the case of companies and other concerns working under special

Acts of Parliament and regulations, it must be seen that all the transactions are *intra vires*, and, therefore, the auditor must make himself familiar with all the legal documents and acts affecting the particular undertaking.

Business Assets

Time is not available in which to explore all the possibilities of this side of the question. I must, therefore, deal with this subject in broad outline only.

On the purchase of an asset, the auditor must vouch the original payment with documents showing the amount and particulars of this item, and he must satisfy himself that it is a proper capital charge. For example, in the case of plant and machinery, he must see the invoices and receipts, and ascertain that the purchase represents additional plant, and not replacements, when the original item has not been written off entirely by means of depreciation. A purchase of freehold property will be vouched with the contract of sale, and the solicitor's statement showing the purchase consideration.

Subsequently, at the date of each Balance Sheet, he must see from the books what assets should be in hand, and then verify their existence. The exact form of verification differs with the nature of the asset. For example, in the case of cash, the actual balance should be counted; investments will be verified by an inspection of share certificates, bonds, etc.; freehold property with the title deeds. When carrying out this verification, great care must be taken, not only that the documents are genuine and held in the correct names, but also that fraudulent duplication does not take place. If there are several cash balances in one business, and all are not counted at one time, the same cash may follow the auditor round, and be produced to him when counting each balance. When examining securities, such as bearer bonds, the same bonds may be produced more than once if special precautions are not taken.

We now come to the question of the valuation of all the assets of the business for Balance Sheet purposes, which is one of paramount importance. The results shown by the Profit and Loss Account, and the position shown by the Balance Sheet, depend entirely upon the valuation of the assets. This valuation must, of necessity in many cases, be dependent upon the personal opinion and judgment of the officials of the concern, and, therefore, it is a simple matter for such valuation to be improperly manipulated. The auditor must, therefore, satisfy himself that the valuation of the assets is fair and reasonable, but with different classes of assets and in different businesses, various bases of valuation are adopted; the auditor cannot, therefore, act upon any "rule of thumb" method. The whole of the circumstances of the case must be taken into consideration; the auditor must test the valuation in every way he can, and by means of intelligent inquiries satisfy

himself; technical questions are involved in many cases, and, therefore, the auditor requires great skill, experience, and judgment when dealing with this question. He cannot have expert knowledge, and he must rely upon the officials of the concern for information and explanations. In most cases, therefore, the detection of fraud will depend upon his judgment of the evidence and explanations put forward. The question of depreciation of fixed assets raises a very wide and complicated subject, and in any cases where the auditor is not satisfied, he should report to that effect. He is not in a position to fix depreciation rates, but he must satisfy himself as far as he can that the provisions made are sufficient.

A common form of falsification of accounts is by means of stock-in-trade; the quantities included, or the valuations may be falsified, and these frauds are difficult to detect. It is impossible for the auditor to take, inspect, or value the stock, nor is there any certain means by which he can verify the existence of this asset. There is, therefore, a common contention that an auditor can assume no responsibility further than routine checking of castings and calculations, and that he can safely depend upon the certificate of a responsible official. If this contention were correct, and audit would be no safeguard to shareholders, as the official responsible for the valuation of the stock can manipulate the accounts at will; the position is the same as if every link in a chain were tested except one, in which case, the whole test is valueless.

An auditor can, and must, take reasonable precautions; he should, therefore, investigate the whole system of stock-taking, and ascertain whether the whole is checked independently. He must also examine into the whole basis upon which the valuation is made. Some of the tests he should apply are; a comparison of the prices per the stock sheets with current invoice prices, and those in previous years' stock sheets; the tracing of items towards the end of the period into stock and purchases, through goods inwards and order books; tracing large sales towards the end of the period into goods outwards book, and ascertaining that these goods are not included in stock.

In some cases quantity accounts can be prepared, verifying the quantities in stock, and if stock books are kept, these should be inspected. Any marked fluctuation in the percentage of gross profit to sales should be carefully inquired into, as this may indicate falsification of stock.

The foregoing are some of the tests that an auditor may apply to stock-in-trade, and this asset is one which should receive his most careful consideration owing to the facility with which it may be manipulated for fraudulent purposes.

In the time available it has not been possible to deal exhaustively with the subject under consideration, but I have endeavoured to outline the general methods upon which an auditor must work if he is to be

successful in the detection of fraud. In actual practice, you may carry out a great many audits without discovering a single fraud. There is, therefore, a great danger of your relaxing your efforts and becoming mechanical in your work. You students must, therefore, bear in mind that although in ninety-nine cases everything may be in perfect order, yet in the hundredth there may be a carefully concealed fraud, and in this case, on the surface, everything may appear to be absolutely satisfactory. Therefore, success can only be attained by the exercise in every case of great care, skill, and method.

To be successful in the detection of fraud an auditor must be possessed of considerable skill and experience; he must have confidence in himself, based upon a complete knowledge of his profession; he must have common sense, sound judgment, and he must be a judge of character.

I do not wish to give you the impression that an auditor should adopt an attitude of suspicion; on the contrary, it is of the utmost importance that he should be tactful, but if the occasion arises he must be firm, so that he may not be diverted from his inquiries by cleverly conceived explanations. In this, the personal element in human nature plays a great part, and some individuals possess the necessary qualifications in far greater degree than others, but by training, experience, and the cultivation of imagination, the majority can develop these qualifications, and thus attain a considerable degree of success in our profession.

Chapter XX

The Audit and Investigation of the Accounts of Executors and Trustees

A Paper read before the Chartered Accountant Students' Society of London on 13th October, 1909.

WHEN in the spring your committee honoured me by asking me to read a paper in the autumn I promised to do so with a light heart, fully intending to speak upon some subject and of an entirely original nature. This state of mind continued until I vainly attempted to choose my subject. I searched high and low for some undiscovered land, in the describing of which I might subject you to a succession of thrills. This course appeared to me to have the added advantage of sheltering me, for the time being at any rate, from all hostile criticism, owing to what I hoped would be the absolutely unexplored character of my subject. Eventually, however, I decided upon the less exciting and more debateable subject of the "Audit and Investigations of the Accounts of Executors and Trustees."

In the time at our disposal it is quite impossible to describe all the points with which an auditor, in practice, may have to deal when auditing these accounts. My intention therefore is merely to point out to you the lines upon which such audits should be conducted, and, in doing so, to deal with some of the points upon which I have had practical experience.

The assets comprised in the estates administered by executors and trustees are often of very varying natures; but I propose describing to you the audit of the accounts of both executors and trustees of estates consisting of the usual assets, including stocks, shares, etc., and landed estates.

In the case of settlements the trustees in some cases do not collect the income during the lives of the life-tenants, who collect the same direct. I shall, however, deal with a full audit of both Capital and Income Accounts.

Although the practice of having Trust Accounts audited is comparatively modern, it has in recent years made rapid strides; but the percentage of trusts whose accounts are audited is still, I think, very small. Owing to somewhat frequent scandals the public is beginning to search for some remedy, and in 1906 an important step was taken, when the Public Trustee Act was passed, whereby a Public Trustee was created for the special purpose of administering trust estates. The placing of an estate in the hands of the Public Trustee is, however, a purely

voluntary act, and this measure does not therefore in any way affect the position as regards trusts not in his hands, except in one particular. By Section 13 power is given to any trustee or beneficiary to call for an audit or investigation of the accounts of any trust in which he is interested, and it must be borne in mind that this section of the Act applies to all trusts, and not only to those administered by the Public Trustee.

In an estate of any size the accounts are often very complicated, and it is absolutely necessary that very complete and accurate accounts be kept, in order that the interests of the various parties may be properly shown and adjusted. The accounts, where there are life-tenants, often spread over a considerable number of years, and the final realization and division of the estate may not take place until many years after the trust was created, by which time, perhaps, the original trustees are dead. If, in the meantime, proper accounts have not been kept, and any dispute arises, as is often the case, between the various interested parties and the trustees, it is a matter of very great difficulty, or, it may be, impossibility, then to prepare a full and correct statement showing the dealings with the estate from the commencement. This may place the trustees in a very serious position. Even if it is possible from the available material to prepare the accounts, it may be found that, through oversight or ignorance, the trustees have not given effect to all the various provisions of the will or settlement and the law effecting these matters, the result perhaps being that erroneous payments have been made to the life-tenants.

When trustees are laymen it is very easy indeed for them to make such mistakes, unless they are properly advised by persons well versed in these matters, and for this reason, if for no other, it appears to be most essential that, in any estate where there are several interested parties, proper accounts should be kept and periodically audited by a chartered accountant.

If the accounts of a trust have been annually audited by a chartered accountant, and the various beneficiaries have been furnished with copies thereof and the auditors' certificates, it is a great safeguard against subsequent disputes arising, as is so often the case in connection with the management and distribution of these estates. Should, however, any such dispute arise, the trustees are in a position at a moment's notice to show exactly how every penny of the funds entrusted to their care has been dealt with, and if they have been properly advised and have acted reasonably it is extremely unlikely that they will have incurred any personal liability. Whilst, on the other hand, if matters have not been conducted on a business-like footing, trustees run considerable risks in this direction.

In large estates, where it is necessary to employ agents, an audit is invaluable, from the trustees' point of view, as a check upon their agents, for whose acts they may be held responsible. Quite recently the late Lord Amherst was held personally liable to the extent of £31,000 on

account of the defalcations of the solicitor to an estate of which he was a trustee, whilst there can be no doubt that, had the accounts of that estate been properly audited, the extensive frauds of which he was the victim could not have been perpetrated.

From the foregoing remarks it will be seen that the position of an auditor to a trust estate is one of considerable responsibility, and one calling for considerable knowledge and skill. Although in principle the audit of such estates is exactly the same as any other audit, there are many special features in connection with these audits, in dealing with which an auditor must use considerable judgment and care.

A knowledge of the law affecting trusts is absolutely necessary, and a considerable number of legal documents have to be read and understood, as it is the auditor's duty to see that the terms of the will or settlement and the law affecting the particular estate have been carried out. Often very complicated questions arise in these accounts in connection with some of the legal rules, and it is most important to see that the same are properly dealt with in the accounts. The auditor is often not able himself to decide how these matters are to be dealt with, but he must have sufficient legal knowledge and experience to enable him to raise the points when necessary. The trustees can then consult their solicitor, and, if necessary, counsel, whilst eventually it may be that application to the Court is necessary before the point in question can finally be decided.

Prior to the commencement of the first audit of an estate of any size there is a great deal of preliminary work which should be done by the principal himself, or under his direct supervision, as the care and skill displayed in this part of the work has the most important bearing upon the subsequent part of the audit. In doing this part of the work, by the use of care and organization, a great deal of time and labour may be saved later on, and especially in the audits of subsequent years. This work consists of the examination of the various legal documents affecting the administration of the estate, and is in many cases a very laborious task. As each document is read through an epitome should be made, most careful notes being made of all matters affecting the accounts. These epitomes should be referenced and filed, so that they can be instantly referred to when required.

The documents to be examined are such as follows—

The Will and Codicils (if any) in the case of a trust created by will.
The Letters of Administration in the case of an intestacy.
The Settlement in the case of a trust created by deed.
The Release and Appointment of new trustees (if any).

Some of the principal points upon which notes should be made are—

The names of the executors or trustees.

The provisions as to the way in which the property is to be dealt with and finally distributed.

The legacies and annuities payable.

The provision as to the maintenance and education of children and the powers of the trustees to make advances.

The provisions as to any special trust created.

The powers of the trustees as to the retention of investments.

The investment clause.

The provisions as to the dealing with the deceased's share in any business.

In the case of landed estates careful notes should be made as to how the following have to be dealt with—Timber cut; royalties; repairs; wasting assets; portions.

Other documents to be examined are any orders made by the Court, and, in the case of a deceased having a share in a business, the partnership deed and the audited accounts of the business.

When an estate consists partly or wholly of landed property the whole of the leases and agreements with tenants should next be examined, and here again, as each document is examined, an epitome should be made. Probably all the leases will be drawn upon a uniform plan; and once this has been carefully examined and understood the examination of the remainder will be comparatively easy, as it is only necessary to see what alterations have been made to meet the circumstances of each individual case. The principal points to be noted are as follows—

Name of tenants.

Description of property.

Period of lease.

The date when the lease expires.

The rent payable.

The provisions as to the payment of rates, taxes, and tithes.

The provisions as to repairs.

The provisions as to the shooting over the property leased.

The provision as to the mineral rights and royalties payable.

The provisions as to the growing crops at commencement and expiration of the lease.

The epitomes should then be filed and referenced, and a summary should be prepared setting out the name of each tenant, the name of the farm or house, etc., the period of the lease, and the rent payable, and a reference number to the epitome. This summary will thus show the annual rental that should be received in accordance with the terms of the leases.

The map of the estate should then be examined in order to see that the whole of the property has been dealt with.

The whole of the insurance policies should next be examined, and a

summary prepared setting out in each case the following particulars—

Number of policy.
Name of office.
Property insured, and the amount for which the same is insured.
The premiums payable.
The date when payable.

In a large estate this preliminary work will necessitate the expenditure of a considerable amount of time and labour, but once it has been completed and the results focused as explained above, it is done for ever, and it is only necessary each year to keep the records up to date by seeing, for instance, the new leases entered into, or noting any alterations made in the old ones, but it will not be necessary to examine afresh all the original documents. When once these schedules have been prepared they will prove invaluable during the audit, and in practice it will be found that reference is constantly being made to them. Consequently in an annual audit an immense amount of time is saved in the long run, and the audit is made much more efficient than would be the case had this part of the work been omitted. By this means the auditor has a complete control over the affairs of the estate, which will prove invaluable at each annual audit, as he has all the information he requires at his finger tips.

When an audit is to be annual the auditor should during the examination of the first year's accounts very carefully consider the whole system of management and book-keeping. He will probably find, if he thoroughly understands this branch of accountancy, that there are several improvements that he can suggest, but in doing so he should use considerable tact. Frequently, in the case of large landed estates, the management is in the hands of a firm of solicitors, and solicitors are as a body very conservative. Especially so are those firms who do this class of work. These estates have often been managed by the particular firm for generations, and the auditor may find it best to carry out his reforms gradually, for if he commences suggesting too many sweeping changes he may receive a very cool reception. If, however, he uses tact and studies his clients in the matter, he will probably find that in the course of a year or two he can get everything run on a proper and up-to-date system, and his clients, on then finding how everything runs like clockwork, will greatly appreciate his services, although perhaps at the beginning he was looked upon as a necessary evil that had to be endured, but not encouraged.

During the course of a first year's audit the principal should very carefully consider the whole of the ground to be covered by the audit, and compile a work diary setting out the whole of the checking and investigations to be done by himself and his staff. In this way it can immediately be seen in subsequent years what has to be done, and the auditor can be certain that nothing is overlooked.

In many well-managed estates it is usual to keep a minute book, in which are recorded the transactions taking place at the meetings of the trustees. In these cases the auditor should carefully read through this book, as it will afford him information upon many important matters upon which, it may be, the financial books are silent.

When auditing the first accounts of executors or administrators the Estate Duty Accounts and Corrective Affidavits (if any) should be carefully examined, in order to see that the whole of the assets and liabilities of the deceased have been included and that the estate books have been opened with these figures. The assets comprised in the Estate Duty Account will probably have been supported by independent valuations, which should be examined. If the originals are at Somerset House, copies should be obtained from the solicitor to the estate. These assets will consist of such as the following—

Furniture, pictures, plate, etc.
Wines and consumable stores.
Jewellery and personal effects.
Horses, carriages, and motor cars.
Cash in house and at bank.
Freehold property.
Leasehold property.
Mortgages.
Stock, shares, and debentures.
A share in a business.

The schedule of debts due at the date of death should be verified by the inspection of the invoices and receipts, as also should the funeral expenses. The books and papers of the deceased should also be examined, in order to see that the whole of the property and liabilities have been brought to account.

In the case of a trust created by deed, it should be seen that the books are opened with the property contained in the schedule attached to the settlement.

Having now completed the whole of the preliminary work, the routine checking of the books of account should be commenced, and the first book to be examined should be the cash book.

In large estates separate banking accounts are often kept for the Income and Capital Accounts, and in the case of settled estates the Capital Accounts are generally kept in a separate set of books.

Taking first the receipts side of the cash book, the items will be verified in the following manner—

The sales of investments will be checked with the broker's sold notes.

Sales of freehold and leasehold property with the auctioneers' accounts, the actual signed contracts, and the solicitor's letters.

The proceeds of life insurance policies with the letters from and to the insurance companies.

Debts due to the deceased, with the letter book, letters, and counterfoil receipt books.

The amounts received on account of the deceased's share in a business will be checked with the audited accounts of the business.

Dividends received will be vouched with the counterpart dividend warrants.

Rents received should be checked on to the rent roll and with the counterpart receipts.

Royalties should be checked with the certified statements of output. In large mines the landlord often has the mine annually surveyed and the lessee's output books checked in this way. In this case the surveyor's certificates should be examined.

Timber sold should be checked with the auctioneer's accounts, or, if sold privately by the local agent, with his accounts and letters.

The miscellaneous income should be checked with whatever available evidence there is, such as agents' accounts, letters, etc., and will consist of such as the following—Cottage rents; underwood sold; sales of game; wayleaves; pole rents, etc.

Turning now to the credit side of the cash book, vouchers will be examined for all payments, which will consist of such as the following—

Debts due at the date of death; funeral expenses; testamentary expenses; annuities and legacies; payments to beneficiaries.

Purchases of stocks and shares will be vouched with the broker's bought notes.

Estate duty with the receipted duty accounts or probate.

Legal charges with the solicitor's bills of costs.

In the case of landed estates there may be payments for buildings erected and repairs and alterations to existing buildings, and these payments should be supported by builders' contracts and vouchers and architects' certificates.

In landed estates the custom often is for the landlord to provide the tenant with the materials for ordinary repairs, and these will consist of straw for thatching, bricks, and timber, etc., and consequently there will be payments for labour and materials, which will be vouched with the accounts of the local agent, supported where possible by receipts. In some cases the materials are supplied from the estate, in which case the auditor should see that proper entries are made to record the same. For example, when part of the timber cut is supplied to the tenants for the purpose of making gates, etc., entries should be made crediting Woods Account and debiting Repairs Accounts of the particular farms, as it is important that the auditor should see, so far as that is possible, that the whole of the timber cut is accounted for.

In order to complete the checking of the cash book the castings and postings will be checked, and the cash book will also be checked with the pass book, and the bank balances certified by means of certificates from the banks.

As explained above, the rents received have been checked from the cash book on to the rent roll, and this should now be checked with the schedule of rents receivable prepared by the auditor from the counterpart leases. In this way he will see whether the whole of the rents have been accounted for or not. Care should be used to see that all arrears from the previous year have been brought forward. Any allowances made to tenants should be carefully scrutinized and the authority therefor examined.

Where there are a great many holdings in stocks and shares a dividend book is generally prepared showing the dividends due and paid each month. In this case the dividends should be checked from the cash book to the dividend book, in order to see that the whole have been brought to credit.

The ledger should next be taken and each account carefully examined. This is one of the most important parts of the audit, as it is here that the whole of the transactions are focused, and the auditor must see that this has been correctly done in accordance with the terms of the document creating the trust and the various legal rules. It is here therefore that the knowledge gained by his examination of the various legal documents is invaluable. If the whole of these have been epitomized the auditor is in a position to do this part of the work comparatively quickly and efficiently, as the whole of the necessary information that he requires is at hand, and it is therefore very unlikely that he will overlook any important points.

Each investment account should be examined to see that the investment is an authorized one, and that the whole of the income therefrom has been brought to credit.

It is necessary to see that all the apportionments between the life-tenants and the remaindermen have been properly made. In the first year's accounts after the death of a testator, and also where one life-tenant has died and is succeeded by another, the receipts and payments on Income Account have to be apportioned. There are also several legal rules affecting the accounts as between life-tenants and remaindermen, and a legal knowledge is necessary to see that any such rules applying to the particular estates have been carried out. These rules often raise very complicated but interesting accountancy problems, in dealing with which considerable care and skill is required.

When examining the insurance accounts the premiums debited should be ticked off with the schedule of insurances prepared by the auditor when examining all the policies. In this way it is seen whether the whole of the policies have been kept up. When part of the estate consists of ground rent and mortgages the auditor should inquire whether the agents have had the whole of the current insurance receipts produced to them.

The accounts can now be checked with the ledger, or prepared by the auditor if, as is often the case, this is left to him. These accounts,

when prepared, should be carefully considered and compared with the accounts of previous years; then, having gone through all the notes made during the audit, the auditor should prepare his report. As the accounts in a large estate are necessarily complicated, the auditor should endeavour to explain the same fully in his report, drawing attention to all points that require consideration and setting out the conclusions to be drawn from the accounts.

Another important part of a trust audit is the examination of the securities. This is sometimes somewhat troublesome if there are a great many legal documents to be inspected. A very good plan in these cases, which is sometimes adopted, is to have an independent solicitor to examine all the title deeds and give a certificate. The auditor can, of course, himself easily verify all the stocks and shares, etc., by examining the certificates or bonds, and, in the case of inscribed stocks, by obtaining certificates from the banks where the same are inscribed. When the examination of the deeds is left to the auditor he is not able to give a certificate that the trustees have a good title; all he can do is to examine the abstract of title, see that all the deeds are produced, and generally satisfy himself that everything appears to be in order. In a large estate this part of the audit, it is submitted, should be performed by a solicitor.

In the foregoing remarks I have dealt entirely with cases where a proper and complete set of books of account have been kept; in practice, however, this is, I am afraid, the exception and not the rule. Often the only book kept is a cash book, in which case either a ledger will have to be opened and posted up or an analysis will have to be made of the receipts and payments. In these cases it is most important to make certain that the commencing figures are correct. In the case of settlements, the schedule attached thereto will contain details of all the property, and this must be traced through. In the case of a trust created by a will, the estate duty accounts and schedules will contain the details with which the account should commence. A good plan where the transactions are not very numerous is to prepare sheets with four columns, in the first of which will be entered the property at the commencement of the period of the investigation; in the second, the assets purchased during the period under review. In the third column will be entered the proceeds of assets sold; whilst the fourth will contain the property in hand at the close of the period. A statement can then be prepared embodying these totals and making adjustments for profits and losses on realizations, and the various payments made out of capital moneys. In this way it can readily be seen whether the whole of the property has been accounted for or not.

Where the Income Account has to be audited as well as the Capital Account, it will probably be found, if the estate is of any size, that the shortest and best method is to write up a proper set of books. In this way a permanent record is created, showing exactly how all the figures

contained in the final accounts have been arrived at. This may prove of great value in after years, if the accounts have again to be examined by persons other than those who originally prepared them.

In my opinion the audit of the accounts of trust estates will in the future become much more general than it is at the present day, and possibly even it may become compulsory by law. The subject is one therefore which merits the careful attention of all students, and I hope that this paper may be of some service in this direction.

Chapter XXI

Government Contract Cost Investigations

A paper delivered before the London Members of the Institute of Chartered Accountants on the 27th April, 1942.

THE subject that we have to consider is Government Contract Cost Investigations, and I think perhaps in opening the discussion the most helpful thing would be to outline to you the negotiations which the Federation of British Industries has for some time been carrying on with the Treasury on this specific subject, because as the result of those negotiations a code of costing has been settled by the Treasury, and this is the code which governs all cost investigations to-day.[1] I happen to be chairman of the sub-committee of the F.B.I. which dealt with that matter.

As we all know, this subject arises because the Government has the right to investigate costs in connection with any Government contract, and I do not think any of us will quarrel with that. Each of the various Government departments have, and had, their own cost investigation departments. Sometimes they investigate on the completion of a contract to see whether costs and profit are reasonable, and in other cases, when estimates are prepared as a basis for fixing a contract on a fixed price basis, they investigate before the contract is placed. In both cases the yardstick, of course, is what is the cost and what is the profit margin that has been added to it, and are both reasonable or not.

The way the F.B.I. came into this was as follows. They have a War Contractors' Committee, and at that committee complaint was raised that, like the grasshoppers to the children of Israel, cost investigators were becoming a burden in the land, the point being that where the contractor was dealing with a number of Government departments, he had a different cost investigator coming from each department, each investigator wanted to plough through the whole of the books, to go through all the overheads and decide what was allowable and what was not and each investigator seemed to have different ideas. There did not seem to be any "book of rules" that the unfortunate contractor could refer to, and therefore complaint was made and a request put forward that the F.B.I. should do something to try and straighten this matter out with the Treasury. Therefore a sub-committee was set up to deal with it, the points being that the F.B.I. should firstly press that the Government departments should eliminate investigations of the same set of books by a number of different cost

[1] Reprinted as an Appendix, see page 257.

investigators, and that these investigations should be centralized in some way so that each contractor dealt with only one cost investigation department and not several as was the case with many. Also that the F.B.I. should press that the Treasury should lay down a code of basic principles of costing as a guide to both the investigators and the contractors.

As a result of these negotiations with the Treasury to a large extent the duplication of cost investigations has been eliminated, and you will judge for yourselves how satisfactory the other part was.

The sub-committee, when it got to work, found that there was a document called the Colwyn Report, which some of you may have heard of but many of you no doubt have not, but it is interesting to note that during the last war exactly this same need arose, and the Colwyn Committee was set up to do just what the Treasury has recently done, i.e. to settle a code of costing principles governing the costing of Government contracts. The date of that report, it is interesting to note, was 31st October, 1918, so it was a little late to be of any use so far as the last war was concerned, but that Colwyn Report is still in existence in the archives of the Government departments, and it appeared that in arguing costs with a contractor the departments from time to time quoted the Colwyn Report. On the other hand contractors did not know of this report. As a result of the F.B.I. negotiations we have put the Colwyn Report to death and a new code has taken its place.

The F.B.I. attacked this problem in two parts, firstly costing, and secondly—a much more delicate problem—the profit margin to be added to the cost. The first has been concluded, but the second has not.

The F.B.I. in its memorandum to the Treasury firstly pointed out that a large number of Government contracts were based on cost plus a percentage, which, it was suggested, was a bad principle, and which was further complicated by the formula that the Government used for arriving at the profit percentage, which is based on turnover of capital. If, for example, a contractor turns over his capital once a year, the profit percentage might be 10 per cent. If he thereafter by energy, initiative and drive increased his turnover of capital to twice per annum, his profit percentage would fall to 5 per cent, which would still give him 10 per cent per annum on his capital. This system, as you will appreciate, takes away all urge to increase production, because the contractor gets no benefit whatever for his increased efforts, and the inefficient contractor benefits at the expense of the efficient one. The Treasury said they did not understand this, but I think you will readily agree that 10 per cent profit on inefficient costs means more profit per unit of production than 10 per cent on efficient costs.

The F.B.I. argued that cost investigations seemed in many cases unnecessary, as 100 per cent E.P.T. was roping in to the Revenue excess profits anyway. The Treasury reply was that E.P.T. only limits profits and that the great bulk of Government expenditure was

in the cost of production, which they therefore reserved the right to investigate. I think we cannot very well argue against that. The F.B.I. argued that it was increasingly important to avoid the expenditure of unnecessary time and effort both on the part of the accountancy staff of the contractor and also the Government. It was argued therefore that the departments should cut out cost investigations wherever there was an established market price for the particular products and that such market prices should be accepted. The Treasury pointed out that market prices might include excessive profit margins which would not be acceptable to the Government.

The F.B.I. also pressed that the departments should be content to accept the contractor's auditor's certificate as to costs, the Government, of course, reserving the right to investigate any cases they wished to, but that that right should be used sparingly.

The Treasury agreed that cost investigations should not be resorted to unless there was prima facie evidence that prices had been inflated, or where there was no time to adopt normal procedure, or where, owing to the novelty of the nature of the work, such as ship repairs, it was impossible to arrive at a proper pre-estimate of cost.

The F.B.I. also pressed that the Treasury should lay down in the form of a code the general principles of costing to guide both investigators and contractors. That the Treasury agreed to, and it has been done.

The Treasury agreed that the duplication of cost investigations should be abolished, and they laid it down that the department most interested in the contractors' production, that is to say, the department taking the greatest volume, should investigate on behalf of all departments. In my own experience that has been done, although I have heard other contractors complain that they are still getting investigators from several departments.

Coming to the details of the negotiations regarding costing, no great difficulty arises regarding prime cost which represents, of course, the direct labour and materials going into the product, and it is simply a question of identifying this expenditure and thus arriving at the cost. There are little points in connection with materials, which are not quite so important now, but were of importance in the early days of the war. One is where a contractor takes materials from stock and uses those materials for Government contracts. When the war started many contractors were well bought and had heavy stocks, and upon the outbreak of the war prices rose and therefore such stocks often stood in the contractor's books at prices materially lower than the market price when a Government contract was entered into. In these circumstances, if a contractor used his own stocks for such a Government contract, the F.B.I. claimed that the contractor should be allowed to charge the replacement price, on the ground that he was using stock acquired for his civilian business and which he would have to replace. Alternatively, it was argued that if the contractor did not want such

stock because, for example, his civilian business had fallen off, then he was in a position in many cases to sell that stock and make his profit, subsequently purchasing specifically the raw materials for the Government contract. The Treasury would not give way on that point and insisted that the cost of materials must be the average of all purchases, including stocks. They did say, however, that special cases would be considered, but ordinarily the average cost of raw materials must be taken.

Another point is that in the early days of the war many contractors, very wisely, when they obtained Government contracts, specifically covered themselves for the raw materials—it was possible at that time to place forward contracts. The F.B.I. claimed that where a contractor had adopted this prudent practice, that he should be allowed to charge the actual cost price of those materials specifically bought for that contract. The Treasury would not agree but insisted upon an average purchase price including stocks, but stated that special cases would be considered.

Scrap and residual materials arising out of a contract are, of course, a credit to the costs of the contract.

Coming to overheads, which are the crux of the whole matter, the first point argued was as to what should be the basis of allocating the total overheads as between the civilian business and the Government business. In the case of a contractor whose business included (*a*) home civilian business; (*b*) export; and (*c*) Government contracts, the F.B.I. argued that the total of the overheads, including manufacturing, selling, distribution and administration should be allocated *pro rata*, taking the business as a whole. It was pointed out in most businesses the trend was for Government businesses to increase and civilian business to diminish, and therefore if overheads were not allocated in that way the reducing civilian business would be saddled with an increasing burden of overheads. It was argued, therefore, that the basis of spreading overheads to the Government business should not be by taking them item by item and only allocating to Government business overheads which could be specifically earmarked as being in connection with that particular business. Taking advertising as an example, the argument was that advertising which increased the volume of civilian business was helping the Government business by increasing the spread of overheads. It was admitted by the F.B.I. that the contractor must satisfy the Government that the level of any expenditure was in reasonable relationship to pre-war levels, and that applied to such items as advertising, salaries, commissions, subscriptions, donations, and items of that kind. The Treasury, however, replied that pre-war level was not necessarily an acceptable minimum. Regarding the general basis of allocation, the Treasury stated that items that could not be readily identifiable as a direct cost of a unit of production could be dealt with by two alternatives. One was to spread such items over the business as a whole as the F.B.I. was claiming and the other was to spread such

expenses over the range of products to which the expenses related. The Treasury's view was that it was a matter of opinion and judgment and that in some cases the F.B.I. basis would be acceptable, but that in others "greater precision is sought."

Then referring to selling expenses—always a difficult problem—the Treasury stated that—

"A uniform spread is indefensible and unacceptable. We have considered whether it is possible to assist industry by giving more precise guidance. . . . It is difficult to do so as, in general, cases will have to be settled by discussion of their individual merits between the Government accountants and the individual company. The most we feel able to say is that—

> "(*a*) Selling expenditure, including advertising, will not be excluded in principle as an item of overheads.
>
> "(*b*) Within the limits of a reasonable quantum of expenditure it will be allowed as an overhead where, and to the extent that, it can be reasonably demonstrated that to do otherwise would mean throwing on to private trade an undue proportion of total overheads.
>
> "(*c*) We should take especial care to see that a company which had turned over to Government production was not unfairly treated in comparison with piece-time competitors who are continuing their civil work, assuming always that selling expenses were kept at a reasonably low level.

"(It is to be noted that the Select Committee considered the general principle for which the Federation contends. It said that it has been advanced that the overheads to be borne by Government work done by firms with a decreasing civilian business should be a fair proportion of the whole overheads, including advertising and selling. It is important that these commercial organizations should be maintained, but they could not agree that a subsidy for their maintenance should be derived from overheads improperly attributed to work to which they do not relate. A solution of the difficulty is required and must be sought by other means.)

"With regard to all overheads, the Treasury agreed that any costs common to both civil and Government work must be equitably spread subject to the total cost of the product being reasonable, and reasonable in relation to pre-war levels. This must not be taken to mean that pre-war profit margins are necessarily an acceptable minimum."

You will see, therefore, that this question of dealing with this difficult group, namely, selling expenses, is left open to individual argument, and the Treasury has not slammed the door in the contractor's face; the door is ajar and it is up to the contractor to push it open.

Regarding manufacturing overheads no great difficulties arise. The Treasury have agreed that the following can properly be included—Works staff and operatives endowment, pensions and provident

benefit schemes, holiday pay, war risk insurance, technical and test expenses, research, allowances for defective products, works canteen expenses, obsolescence losses, alterations and re-arrangements of plant, the cost of training labour, A.R.P. and other war emergency expenses. Regarding royalties and maintenance of patents, these will be allowed if they are in connection with products which are being manufactured for the Government, but if they are in connection with products solely for civilian business they will not be allowed.

The decision regarding Service allowances is rather strange. Service allowances to sales and administrative staff can be included in overheads but similar allowances to production staff and operatives will not be allowed. That seems most illogical but the Treasury argument was that Government ordnance factories do not give Service allowances to their operatives and therefore private contractors would not be allowed to include such allowances in their costs.

With regard to depreciation of fixed assets, as no doubt you know, all that may be included in costs is the Inland Revenue wear and tear allowances. The F.B.I. argued that in many cases the contractor had to put in special plant for these Government contracts which plant would be useless to him after the war and he ought to be allowed to write it off over a short period of years. The Treasury answer was that it would be impossibly complicated to agree fresh rates with every individual contractor, and, furthermore, they pointed out that the 1937 Select Committee on Estimates ruled against allowances for special plant for Government contracts.

Regarding the basis of allocation of manufacturing overheads, any commonly accepted basis will be agreed, for example, direct labour, man-hour rates, machine-hour rates, or rate per unit of production—whatever reasonable method has been adopted by the contractor will be agreed—and the same with selling and distribution expenses, the Government will agree any reasonable basis of allocation.

Coming to selling, distribution and general administration expenses and the disputable items. Advertising I have already referred to, but generally the Treasury argument is that if the Government purchase goods at market price they have, in fact, borne a fair proportion of the advertising expenses, but if they are buying at a special price and if the advertising is solely for non-Government orders, then the allocation of any portion of the expenses will only be admitted on the broad ground of policy. They have not slammed the door; and therefore it is up to the contractor to make out his case and if he can make it sufficiently strong there is the possibility that some portion, at any rate, will be allowed.

Bad debts, the F.B.I. argued, were simply a necessary expense of carrying on a credit business, and as the credit business swelled the volume of sales, the Government benefited in the spread of overheads. But the Treasury were adamant; they would not allow any bad debts because they say bad debts do not arise on Government work.

The Treasury agreed that the following could be included in selling and general administrative overheads—the cost of endowment and pension schemes, A.R.P. and war emergency expenses, war risks insurance, and Service allowances, and the following, they said, were not normally admissible but were open to consideration on the facts—export expenses—an important item—market research and development expenses, and price policy concessions.

Carriage and packing, it was agreed, is usually a direct charge, and the Treasury said "If, however, the Government goods are delivered home and it is the firm's practice to include these as overheads, it will be allowed."

Directors' fees, the Treasury stated, would be considered on their merits having regard to the status of the company, whether it was public or private, the pre-war level, and whether the directors were wholly employed by the contractor. We could not get them to be any more specific than that.

They agreed to admit evacuation expenses but said that any capital expenditure must be treated as such, and, therefore, if a contractor purchased a mansion in the country the cost of the mansion would be capital.

It was agreed that financial charges should not be included in costs, and that covers, of course, interest on debentures, loans and advances; premiums and discounts on shares and debentures; commission on placing shares and debentures; underwriting commission on placing shares and debentures; and issue expenses. On the other hand, interest on surplus funds is not a credit to costs.

Regarding cash discounts, the Treasury claim that discounts on purchases of raw materials, supplies, etc., must be deducted from the cost of such materials, etc., and discounts on sales they regard as a deduction from the selling price. Sundry items, like salvage, rents received and interest received are not a credit to costs.

Regarding sub-contracts, if the contractor is getting a percentage on cost, he will not be allowed that same percentage on the cost of work carried out by sub-contractors. Inter-departmental charges and charges by subsidiary companies have to be disclosed and also the amount of profit (if any) included because a contractor must not pyramid profits.

In conclusion, these negotiations, I think, did achieve something helpful as regards the avoidance of the duplication of cost investigations, but as regards the Treasury code of costing principles I cannot say, speaking for industry, that we are by any means satisfied, but it does cover a lot of the ground and from personal experience I am of opinion that it has saved a considerable amount of time in concluding these cost investigations.

Regarding the profit margins on Government contracts, as you know, the percentage is regulated by the turnover of capital, and there

what the F.B.I. wish to get defined is how to calculate the capital and turnover, but as these negotiations are not concluded I cannot say anything about them.

Discussion

In the course of the discussion which followed—

Mr. Fitzwilliams asked whether any allowance was made for deferred repairs.

Mr. de Paula: I do not think we referred to that specifically. I think you should certainly claim it. I cannot remember that we actually argued that particular point, but certainly in equity you are entitled to claim an allowance for deferred repairs.

A member said that different Government departments had different ways of dealing with deferred repairs, and pointed out that the M.A.P. did make an allowance under that heading. He asked if the lecturer could give any information as to the profit rates allowed by the various Government departments, and also a comparison of the stringency of the cost examinations of the respective departments.

Mr. de Paula: Regarding the profit rates, where the departments were applying the formula, nowhere in black and white have they ever admitted what their basic percentage was, but they seemed to be working originally on 10 per cent if your capital was turned over once in a year, but so far as I can judge at the present time they seem to be working on about 7½ per cent on a capital turnover of once a year.

With regard to the stringency of the cost examinations of the different departments, they all seem to have totally different methods; there is no uniformity, but they are all working, when it comes to investigating costs, to this new code.

Mr. Wrigley pointed out that in his experience the Ministry of Supply accountant would not allow that part of the war risk insurance premium which related to stock the ownership of which vested in the Government immediately on purchase by the contractor.

Mr. de Paula: Generally, war risk insurance is allowable.

A member asked whether it was possible, when considering the profit rate, to be allowed to take into consideration those companies which were not interested in profits. That sounded rather Irish, but he referred to those companies which were earning profits in excess of their E.P.T. standard and who were being asked to extend their business for Government purposes. The position at the moment was that they were being asked to take the risk of loss without any possibility of profit, and many boards of directors were seriously considering whether they were fulfilling their duty to their shareholders in taking on this extra work, although it was in the country's interest that they should do so.

His second point, he said, referred to the question of loose tools. Where a company was asked to carry out extensions, the capital cost

being paid by the Government, the rule seemed to be that the company must pay for its loose tools. In many cases the company would not want those tools after the war, but it had to find finance for them. It seemed to him that the cost of loose tools should be an allowable charge as regards income-tax, E.P.T., and contracts. Thirdly, he said, he would like to know whether any arrangements had been made for appeal in cases where a difference of opinion arose with the investigating accountant.

Mr. de Paula: On your first question, I quite appreciate your point, and what the F.B.I. has argued, and argued very strongly, is that the whole method of calculation is a thoroughly bad one, because it works against a firm extending its production. As you have indicated, not only does it give a firm no urge to extend, but it is hurting itself by racketing its plant to pieces working overtime. The Government policy would appear to be moving more and more towards fixed price contracts. I think it is well worth while for contractors to get into touch with the particular department concerned and try and evolve a scheme whereby they get fixed price contracts which give them some incentive to increase production in the national interest. Of course, E.P.T. will claim the extra profits but, at any rate, there is the 20 per cent that will one day, we hope, come back to roost. Further than that, I think we cannot go.

Your second point was with regard to loose tools. I entirely agree with you, and I do not think that one should have much difficulty in getting loose tools written off very quickly.

Your third point was the position in the case of a dispute. I am afraid at the moment there is no court of appeal and therefore you are very much, if not completely, in the hands of the investigator, but if it is a question of principle that is involved and you totally disagree with the investigator's ruling, the thing to do is to go as high up in that department as you can to argue your case, and I think you will find that they are not unreasonable and there is hope, if you put your case well, that you will get a favourable decision. Apart from that I do not think there is anything you can do.

Mr. Pagnamenta asked whether it would be possible to get copies of the Treasury report to which Mr. de Paula had referred, as it would be most interesting to study it at one's leisure. His second point, he said, arose out of Mr. de Paula's suggestion that individual firms should press for fixed price contracts whenever possible, and he would like to ask whether it would not be advisable to carry it a stage further and endeavour to obtain a uniform price for the product. In the iron and steel industry there were uniform prices and always had been, and the Government there were willing to accept certain cost checks. An enormous amount of the nation's time must be spent now in the investigation of individual contracts, and if by a routine investigation of a number of firms in the industry a price could be established for certain recognized production he felt it would be a great advantage not only to the industry but to the Government.

Mr. de Paula: Regarding your first question, I have no doubt you could get copies of this report from the Federation of British Industries. Regarding your second point, I think it is a matter for the individual industries and I think myself that the Government would welcome it, but it is not always quite so easy. I know industries where it would be impossible because it would go very much against the smaller man. There are many industries where you have got one or two very big firms who have a very low cost of production, which a small man could not look at, and you would find it extremely difficult to fix a price for those industries that was not very hurtful to the small man, or if you gave him sufficient the big man would be making much too much. But I think where it would work fairly in an industry, if the industry argued it with the Government they would be pushing at an open door and the Government would probably welcome it.

Mr. Robson said he had recently had some experience with the diesel oil industry, which industry as a whole negotiated with the departments and made the very points that had been mentioned. The attitude of the Government was that they were quite prepared, indeed anxious, for fixed price contracts because they found their resources in the form of cost accountants and so forth were quite inadequate to check the cost plus contracts, so recommendations had been sent out to the industry that they should endeavour to negotiate fixed price contracts by reference to the formula of a percentage increase to cover the increased costs of labour and materials over and above the standard price of the product in some pre-war year.

He believed in one industry they were taking the year 1935 for the standard price of the product and adding 25 per cent to that for all contracts placed before December, 1940, and a further 5 per cent on contracts placed after December, 1940, and fixed price contracts on that basis had been handed out. They had also made the further recommendation that those industries should on no account agree to contracts with a maximum price for novel products, such as prototype gun mountings or aeroplane parts, because in such circumstances the manufacturer possibly did not know what trouble he was running into with modifications and so on. If he accepted a maximum price contract and found he had incurred a loss, he was not reimbursed, and so the recommendation had gone out to the industry that under no circumstances should they accept that type of contract, but preferably for types of production which did not lend themselves to fixed prices, the contract should be for cost plus for an educational period until the manufacturer obtained some knowledge of the cost incurred, and he should be encouraged to negotiate for a fixed price contract after the educational period.

He said he found some manufacturers in the iron and steel industry very worried over the supply departments endeavouring to exclude any clause relating to increased cost of labour and materials if a fixed

price contract was entered into, which he thought was rather an error because one could not envisage prices and anticipate wages and materials, and there was always the question of loss arising from *force majeure*, such as the bombing of the factory.

Mr. de Paula: I know of many cases where fixed price contracts have included a material and labour variations clause, and that is necessary. I should have thought that should be arranged in your case.

Mr. Ambler said that the speaker in dealing with overheads referred to directors' fees, and asked what yardstick there was, if any, for dealing with directors' remuneration.

Mr. de Paula: Unfortunately the Treasury would not be specific. They simply said they would judge each case on its merits. They gave us no indication of what yardstick they would use.

Sir H. Howitt said he was sure they were all very interested in the lecturer's remarks on the accountancy difficulties that arose in all these problems of cost investigation, and he would like to ask if there was any way of avoiding those problems. On the one hand there was a shortage of accountancy staff and on the other hand it was necessary to have some kind of control over the expenditure incurred by contractors so that demand on the resources and labour of the country was reduced to a minimum. Those were two extremes and it was necessary to steer between them. All sorts of schemes had been put forward to try to do so, and he asked if the lecturer could make any suggestion with the object of reducing the demand that is thrown on the accountant's time at the moment.

Mr. de Paula: There is one method which would save a considerable amount of time and that is if the departments would agree that they would not do their investigations at the end of the year—which means after the end of the financial year, which in turn means you cannot make up your accounts or know where you stand because you do not know how much they are going to ask back from you or what percentage they are going to give you. If instead the department would fix the percentage for the coming year on the basis of the past year so that you knew exactly what your percentage was for the coming year and that it would be unalterable, then, if on this basis they would fix contracts for (say) three-monthly periods in advance at fixed prices, the department having the right, of course, to investigate costs when the contractor was submitting his quarterly prices, by such a method the number of investigations could be reduced. Wherever possible some sort of fixed price scheme is, I think, the solution, but different industries would have different circumstances and I do not think it would be possible to lay down any scheme that would be fair for all industries.

Mr. North asked if Government departments made any allowance for exceptional depreciation.

Mr. de Paula: What you are allowed for income tax you will be allowed for this purpose. They simply follow the income tax allowances

A Member asked if any information could be given as to how capital was to be calculated.

Mr. de Paula: That is a subject which the F.B.I. has not finished with. It is a very complicated subject. Time is getting on and calculation of capital and turnover are subjects on their own, and I think it would be very late if we went into that now.

A vote of thanks to the lecturer was carried with acclamation.

APPENDIX

STATEMENT AGREED BETWEEN THE F.B.I. AND THE TREASURY

The agreed Statement, drawn up as a result of the discussions between the F.B.I. Committee and the Treasury is reproduced below

GOVERNMENT CONTRACT COST INVESTIGATION

Report of Representations

In War Circular No. 41, members received a note of representations made to the Government on Cost Investigation of Government Contracts. Since these were put forward discussions have been carried out with the Treasury, as a result of which an agreed statement has been drawn up.

This is reproduced below in the hope that on the basis of points now agreed, members may be assisted in settling difficulties in connection with their individual contracts.

1. The Federation submitted that the basis of cost plus a percentage for profit was undesirable for contract purposes, giving as reasons that—

(*a*) the reward to the inefficient manufacturer whose costs were high would be greater than to the efficient manufacturer;

(*b*) in the majority of cases cost investigations serve no useful purpose. Now that the rate of E.P.T. is 100 per cent, any excessive profits, which cost investigation is intended to prevent, will, in the majority of cases, find their way to the Exchequer by another route.

(*c*) it is increasingly important to avoid unnecessary labour.

It is therefore suggested that—

(1) where there is an established market price, that price should be accepted;

(2) a certificate from the manufacturers' auditors as to costings should be accepted, while the department should hold in reserve the right to investigate costs.

(3) the right to investigate cost should be used sparingly, as the system is wasteful of skilled clerical labour both in Government departments and manufacturers' staffs;

(4) general principles governing costing should be agreed to obviate delays and disputes;

(5) duplication of cost investigation by departments should be avoided by the institution of a unified staff of Government cost accountants.

2. In reply it was agreed that the cost plus a percentage basis was undesirable. It was stated by the Treasury that the criticism (*a*) above was not understood (but it is to be noted that it has since been referred to in the case of cost plus percentage by the Select Committee on National Expenditure, Fourth Report). It was added in regard to

(*b*) that E.P.T. only limited profits. The great bulk of expenditure was represented by production costs which must be investigated. With regard to (1) it was contended that an established market price might include an excessive profit margin.

3. Generally speaking it was accepted that cost investigation should not be resorted to unless there is prima facie evidence that prices are inflated against the Government, or the contract is of such urgency that there is no time for the normal procedure, or where by reason of novelty or the nature of the work, e.g. ship repair, it is impossible for either party to arrive at a proper pre-estimate of cost. (This guiding line is accepted by the Select Committee which, however, suggests that even in ship repair work, much can be done to avoid cost plus contracts. It also throws doubt on the urgency argument on the ground that proper preparatory work speeds up, not delays, completion of the contract. It also puts the place of "target contracts" between contracts costed on the ground of novelty and fixed price contracts which should be used when straight run production is reached.)

4. It is accepted that duplication of cost investigations by different departments should be abolished. It has since been stated in the House that this is to be achieved by all costings for a contractor being done by that department most interested in his production.

5. With regard to (2) the employment of a contractor's own auditors is being introduced on an experimental basis.

6. With regard to (4)—agreement on general principles of costing—it was pointed out by the Treasury that contractors all have their own costing systems which could not be reduced to strict uniformity. (The Select Committee urges that the more this can be done within any one industry the more informative will costings be.) In reply to the Treasury the Federation explained that it intended to suggest agreement on general principles and not in such detail as would entail recasting any contractor's costing system. The Treasury agreed that the suggestion that there should be a code of general principles to which Government investigators should work is one which merits the closest consideration, and various disputable questions of principle were discussed.

Prime Cost

7. With regard to prime cost it was felt that this seldom gave rise to dispute. The Treasury, however, point out that the departments must be free to disallow any costs which are unreasonable, such as arise from over-purchase of materials or labour not necessarily employed on the contract. Further, it was agreed that scrap and residual raw materials should be credited to costs.

8. The Federation contends that where a contractor uses on a Government contract materials which he has in stock, the replacement value, and not the cost, should be taken. The Treasury does not agree. It was pointed out by the Federation that a contractor might have

purchased such materials for the purpose of his civil work and might divert them to a Government contract to save time, replacing them when free to do so. In reply it is understood that such special cases may receive consideration.

Overheads

6. The most important of the disputable points was the general principle urged by the Federation "that all Government contracts should bear a fair rateable proportion of manufacturing, selling, distribution and administrative expenses of the business taken as a whole." In support of this it was advanced that any expenditure resulting in increased civil work benefited, by the spread of overheads, both the civil and Government work. In reply, the Treasury stated that—

"The extent to which a charge not readily identifiable as a direct cost of a unit production should be spread over the business as a whole, or merely over the range of product to which it relates is in many cases a matter of opinion and judgment in which the conflicting claims of equity and simplicity have to be balanced. In some cases it is acceptable to spread overheads *pro rata* over the whole business. In others greater precision is sought. Selling expenditure covers so wide a range of service benefiting individual products in such differing degrees that so far as Government orders are concerned, a uniform spread is indefensible and unacceptable.

"We have considered whether it is possible to assist industry by giving more precise guidance. . . . It is difficult to do so as, in general, cases will have to be settled by discussion of their individual merits between the Government accountants and the individual company.

"The most we feel able to say is that—

> "(*a*) Selling expenditure, including advertising, will not be excluded in principle as an item of overheads.
>
> "(*b*) Within the limits of a reasonable quantum of expenditure, it will be allowed as an overhead where, and to the extent that, it can be reasonably demonstrated that to do otherwise would mean throwing on to private trade an undue proportion of *total* overheads.
>
> "(*c*) We should take especial care to see that a company which had turned over to Government production was not unfairly treated in comparison with peacetime competitors who are continuing their civil work, assuming always that selling expenses were kept at a reasonably low level."

(It is to be noted that the Select Committee considered the general principle for which the Federation contends. It said that it has been advanced that the overheads to be borne by Government work done by firms with a decreasing civilian business should be a fair proportion of the whole overheads including advertising and selling. It is important that these commercial organizations should be maintained, but

they could not agree that a subsidy for their maintenance should be derived from overheads improperly attributed to work to which they do not relate. A solution of the difficulty is required and must be sought by other means.)

10. With regard to all overheads the Treasury agreed that any costs common to both civil and Government work must be equitably spread subject to the total cost of the product being reasonable and reasonable in relation to pre-war levels. This must not be taken to mean that pre-war profit margins are necessarily an acceptable minimum.

Selling and Administrative

11. The Federation made suggestions that the allocation of selling and administrative overheads should be based on the net sales value of deliveries to customers. In reply, it was said that there would be no real advantage in disturbing the contractor's existing cost system.

12. If the contractor has received a free issue of materials it may be necessary to adjust the basis of allocation of overheads. The Treasury state that this is usually done by agreement with the contractor.

13. It is agreed that selling and administrative overheads are to include the cost of commercial and administrative endowment and pension schemes, service allowances, A.R.P. and war emergency expenses and war risks insurance. The Federation contends that, in addition, the following should be included—market research and development expenses, price policy concessions and export expenses. The Treasury states that these items are not normally admissible.

14. The Federation contends that bad debts should be included in overheads. The Treasury does not admit this, on the grounds that bad debts are not incurred on Government work.

15. With regard to administrative overheads, it is agreed that these are allowed subject to their being considered reasonable in amount. Directors' fees must be considered on their merits, regard being paid to the status of the company (public or private), the pre-war level of remuneration, and whether the directors are wholly employed by the contractor. Evacuation expenses are in principle admissible but capital expenditure of this nature would be treated as such.

Manufacturing Overheads

16. The Federation and the Treasury were in agreement that the following should be included in manufacturing overheads—

Works staff and operatives' endowment, pensions, and provident benefit schemes.

Holiday pay.

War risk insurance.

Technical and test expenses.

Research.

Allowances for defective products.
Works canteen expenses.
Obsolescence losses.
Alterations and rearrangement of plant.
The cost of training labour.
A.R.P. and other war emergency expenses.

17. The Treasury stated that royalties and maintenance of patents were allowed if they were paid in connection with the production of stores supplied under Government contracts, but that where, for example, payment was for licences for purely civilian production, it was not allowed as an item of overheads apportionable to Government contracts. The Federation submitted that if a contractor had given up his civil production in order to fulfil Government orders the payments he might be compelled to make on minimum royalties and to keep his patents alive, even though not concerned with the product called for by the Government, ought to be admitted. At an interview it was understood that such cases would be considered on their merits.

18. The Federation contends that Service allowances should be included in manufacturing overheads. While admitting such allowances in selling and administrative overheads, the Treasury does not permit them in manufacturing overheads. It is understood that the reason is that allowances are not paid to the personnel of Government arsenals who may join the Forces, and it is therefore held by the Treasury to be illogical to permit contractors to make such allowance at Government expense.

19. The Federation represented that the rates of wear and tear allowed by the Inland Revenue were too low and ought to be increased for contract cost purposes. In reply at an interview it was said by the Treasury that in effect it would be impossibly complicated to agree to fresh rates with every contractor.

20. It was agreed that carriage and packing is usually to be dealt with as a direct cost. If, however, the goods are delivered home and it is the firm's practice to include these as overheads, it will be admitted.

Financial

21. Financial charges, as agreed by the Colwyn Committee, should be excluded. This covers interest, premiums, discounts and commissions on shares or debentures and issue expenses. Equally, interest earned by a contractor on his surplus funds is not to be credited to costs.

GUY LOCOCK,
Director.

SECTION IV
CONCLUSIONS

Chapter XXII

Conclusions

HAVING come to the end of a long journey, it would seem to be necessary to make an attempt to draw conclusions from the observations made and the experiences gained, which, of course, were those of an individual traveller. These conclusions are necessarily personal ones with which naturally many will not agree.

ACCOUNTING PRINCIPLES AND KINDRED MATTERS

The development of the movement towards the improvement in the form of presentation of accounts and the establishment of an agreed code of basic accounting principles can be traced back some twenty years or more. In those far-off days there was a small minority that was not satisfied with the general and accepted *practices of that time*. The Kylsant case in 1930 fell like an atomic bomb and profoundly disturbed both the industrial and the accountancy worlds. It was this event, in the writer's judgment, that gave this whole movement its first great impulse. Directors and auditors of companies immediately commenced to reconsider their methods and practices in the light of the lessons to be learned from that grim case.

Very soon afterwards, accounts of companies commenced to appear in a revised form and which obviously represented an attempt to apply the lessons to be learned from the Kylsant case. The boards of those companies blazed a new trail and great credit is due to them. When some of the big and important companies adopted the new form of presentation the followers grew in number, but slowly at first.

When the Council of the Institute of Chartered Accountants in England and Wales issued its recommendations on accounting principles the movement gathered great force. This further impulse was again increased by the publication of the Cohen Report and later by the Companies Bill.

The basic principles, as now established, represent a revolution in the whole approach to this problem. During the lifetime of the accountancy profession as an organized one, there has been no event of such momentous importance.

The fundamental change has come about, it is submitted, in the most desirable way. It has not been imposed from above by law upon an unwilling public, but the law has followed the existing best practice. Practical men of affairs had read the lessons of the Kylsant case and voluntarily and immediately commenced to evolve accounting principles and practices to comply with them. For example, the Institute's recommendations as regards the form of presentation of accounts,

including consolidated accounts, were based upon the existing practices of many companies that had already modernized the form of presentation of their accounts upon the lines subsequently recommended.

The recommendations of the Institute, regarding depreciation of fixed assets and the vexed question of the valuation of stock-in-trade, many consider to be the most revolutionary of all. Within and without the profession many do not agree with them. The principles, upon which these two recommendations are obviously based, are, firstly the avoidance of the distortion of the true trend of earnings, and secondly the separation of basic principles of valuation from the separate question of prudent reserves dictated by financial policy considerations. The writer is in agreement with the Institute's recommendations upon these two matters.

In both of these cases there is another very important factor upon which opinions differ and that is whether or not the replacement values should govern the provisions for depreciation of fixed assets and the valuation of stock-in-trade. Economists and many accountants do not see eye to eye on this point. This is a field which calls for close and scientific study. At the moment, so far as the writer can judge, the majority of accountants, including himself, are in agreement with the Institute's recommendation upon this point.

The creation, in 1942, of the Taxation and Financial Relations Committee, by the Council of the Institute, and, some years earlier, by the Society of its Research Committee, marks the first endeavours by the profession to think out its problems upon a collective basis. Previously the profession in this country had developed upon a purely individualistic basis. The results of these collective efforts by the Institute and the Society have been remarkable and very far reaching in their influence. This is particularly noteworthy, in view of the fact that each of these Committees is composed of very busy individuals, who can devote to this work only intermittent hours.

These achievements are so encouraging that the writer hopes that this fruitful line of action will be expanded and developed to the full. It is suggested that the profession should set up an organization, upon a full time basis, for the carrying out of research, as the older professions have done. There are still many further territories to be explored for the benefit of both industry and the profession.

Scientific research work is the essence of sound progress in most walks of life, and it is submitted that the accountancy profession in this country badly needs this invaluable help. If some of the best of the rising generation could be encouraged to devote themselves to such work, then, in addition to the results of their research, no doubt these men and women would commence to produce textbooks of quality. Up-to-date accountants in this country have produced few books of the highest quality that have, in marked degree, advanced professional knowledge, and that have developed and improved our

professional technique. The reason is that individual accountants are far too busy with their other affairs to be able to spare the time to write. In the old professions, their great writers almost invariably are found in the quiet and peaceful atmosphere of the Universities.

In America, where the Universities play a leading part in the teaching of accountancy and the development of the profession's technique, there is available, in the writer's opinion, a far fuller, deeper and wider range of professional literature, than exists in this country. That situation is undoubtedly due to the fact that thinking, research and writing upon these matters are mainly carried out in America upon a full time basis and in the quiet atmosphere of the Universities.

The establishing and development of our professional technique is a matter, all will agree, of vital importance to the future of the accountancy profession. In this country, in the past, our technique grew in an uncontrolled and unorganized way. There was little collective thinking and exchange of experiences, but the profession's technique developed mainly upon an individualistic basis.

It would seem, therefore, that this is a supremely important problem that should be constantly in the mind of the profession. In recent years a splendid start has been made, but there is still much to be done and a rapid advance would seem possible only if an organization is set up, upon a full time basis, for the specific purpose of thinking, research, teaching, and writing.

Financial Planning and Control

In this section of the book the reader passes into the world of industry and commerce, the whole of the matters dealt with are a part of the management field.

Forward planning is the basis of successful operation in all fields of endeavour. The Services have learned much regarding the technique and use of planning in time of war and planning is just as essential in order to control effectively an industrial undertaking. Industry might learn much from a study of Service methods.

It is the financial aspects of industrial planning that have been considered, which is a vital and most important part of the whole management problem of operating and controlling industrial concerns.

Far too little consideration has been given to this subject in this country in the past, but it is to-day one of management's burning problems. It may be said to have become a national problem, as it is of supreme importance that the industries of this country shall increase their efficiency to the maximum. The recent reports of the Working Parties have all stressed this vital need.

All those who have been in a position to study the methods of control within industry in this country would, the writer feels confident, testify that the general standard is very low and compares very unfavourably with the general standard in, for example, the United States of

America. As regards the general standards of costing, during the recent war years, the Government departments have seen, at first hand, the costing systems of most of the industrial concerns in this country. The writer believes that the views of the Government officials concerned, if expressed, would be very unflattering to British industry, and by inference, to professional accountants.

There are many concerns that have modernized their methods and the best here would, without doubt, stand comparison with the best in any other part of the world. But it is the raising of the general standard that is so vitally important to the Nation in the most difficult times ahead. When the present sellers market comes to an end, as it inevitably must, our export trade will have to face world competition solely upon a price basis. This British industry will be able to do, only if its general level of efficiency is equal to that of competing nations. All will agree that from the industrial point of view this matter is one of vital importance.

The accountant in industry is obviously deeply concerned with this problem. But where are they to learn how to organize this important part of their control systems? To date, accountants in industry, who are at the centre of this whole matter, have had to build up their systems, almost entirely empirically.

Accountancy practitioners may feel that this subject is no concern of theirs. The writer wonders whether this view is sound? The practicing accountant has been likened to the business doctor; if so, surely he should study the industrial body, its ailments and their cure, just as the medical profession does in the case of the human body. In the medical profession that does not mean that every practitioner is a specialist on every aspect of the human body and its ailments, but the medical practitioner is expected to have a working knowledge that will enable him to diagnose the complaint and decide whether or not a specialist is required to prescribe the cure.

If an industrial concern is sick, accountants are often called in to make an investigation. They can soon ascertain the weaknesses of the financial position, but that may be likened to spots on the human body. The patient knows all about his spots, but what he wants to know from the doctor is what gave him the spots and how are they to be cured. In the case of an industrial concern, the cause of the disastrous financial position, in a great proportion of cases, is that the whole control system is faulty, which may be likened to the nervous system of the human body.

It is, therefore, submitted that it is most desirable that the accountancy profession should study this problem in order that it may render the maximum service to industry. Industry, also, is vitally interested in exploring this whole field. Accountants in industry should be specialists in this subject, as also are certain practitioners and the remaining practitioners should have a working knowledge so that they

could diagnose the ailment and if necessary advise the calling in of the specialist.

In this country the need is for research, literature and teaching in this field. Many will say that this is a matter that cannot be taught and that it can only be learnt in practice. The writer's experience does not confirm this. He found himself in the position of being responsible for teaching this subject in a university, he had little experience and had never seen a financial planning system operated in any business. His only means of learning was to read mainly American literature. Chapters XI and XII in this book are part of the results of this academic study of this problem and of the teaching matter evolved from it. When a few years later the writer went into industry, he had the opportunity to prove out these ideas in practice. It was the irresistible attraction to experiment within industry with these ideas which were all conceived in theory that induced the writer to give up his practice and resign from his University chair.

The result of this practical experiment is shown in Chapters XIII to XVI and readers will observe that the outlines of the original system of control based on theory stands unaltered in the system inaugurated and developed in practice. Naturally it was expanded and developed in many directions but the bases of the teaching, founded on a purely academic study, stood the test of practical experience on a very big scale. Furthermore, the fact that the writer had studied this problem enabled him to proceed immediately in organizing and installing the new system in the company with which he was then associated.

It is this experience that has convinced the writer that this subject can be taught, with great advantage to those entering and already in industry and commerce. This view is confirmed by the fact that the recently formed Institute of Management places education for management as one of its main objects, and that a departmental committee is at present sitting to report upon education for commerce.

The writer is also convinced that professional accountants should all study this subject as a part of their professional education, as a working knowledge of it would enable them to increase greatly their services to industry. Those accountants who specialize in it will open a door leading to a rich field of activity which they will find to be of an absorbingly interesting nature, at least that is the writer's experience.

Miscellaneous

In the paper reproduced in Chapter XVII and which was delivered in March, 1943, the writer attempted to make a survey of the future of the accountancy profession. Two matters that were dealt with were already in train, though the writer was not aware of it at that time. The first was the proposal for the co-ordinating of the practice of public accountancy in Great Britain. It is hoped that this matter will be

completed satisfactorily in the near future. The second was the amendment of the Companies Act, as the Cohen Committee was appointed by the President of the Board of Trade on the 26th June, 1943.

Regarding the position of accountants in industry, there are now two accountants from industry upon the Council of the Institute and many of them are serving upon the various committees and subcommittees of the Taxation and Financial Relations Committee. In these ways accountants in industry are playing an important part in the affairs of the profession. Thus co-operation between accountants in industry and in practice has been effectively achieved and very cordial and satisfactory relations have been established between these two branches of the Institute.

The question of expanding our educational system to cover financial planning and control and kindred subjects has been dealt with above under the heading of "Financial Planning and Control." To establish such teaching upon a satisfactory basis would take many years, as we have very few teachers and textbooks in this field and an essential preliminary would be research work, so as to ensure that the whole of the teaching was built up upon a sound and practical basis.

The building up of a code of accepted accounting principles has been carried out most successfully and has culminated directly in influencing the terms of the Companies Act.

Regarding education, textbooks and research, one very welcome step forward has taken place and that is the establishment of the University scheme, agreed upon by a joint committee representing the universities and the profession. Under this scheme an articled clerk can first attend a university on a full time basis and take a degree and then do his or her practical work with his or her principal and work for the final examination. Under this scheme the articled clerk is excused the intermediate examination.

This is a very significant event, as thus the universities are being drawn into the profession's educational problems and it is sincerely hoped that this scheme will produce teachers and writers, and that it will be developed further.

It is, of course, not yet known as to what proportion of the future members of the profession will take advantage of this scheme. For the remainder of the articled clerks, the old system stands and even under the University scheme the articled clerk will work for his or her final examination under the old conditions and under the old training scheme.

From Chapters XVII and XVIII it will have been seen that the writer, for many years, has been very unhappy regarding the profession's existing educational system. It will have been noted that as far back as 1926 he first raised this matter. Ever since he has been "a lone voice crying in the wilderness" regarding this very important question. Few appear to agree with him. It would seem, therefore, that he must be wrong. But—he wonders.

His only claim to speak upon this subject is that he has seen and taken part in every aspect of it—as articled clerk, as practitioner, as an accountant in industry, as a teacher for about twenty years within the profession and as a teacher for ten years in a university. That experience convinced him that the present system is not worthy of a great profession and is not fair to its articled clerks.

He therefore suggests that the profession should reconsider this vital problem and call in educationists of the highest standing to advise. Training as a professional accountant does not qualify a man as an educationist; the writer certainly would not dare to claim to be one. This surely is a matter of vital importance to the profession and is one, therefore, upon which the best expert advice should be sought.

The fundamental issue is as to how the period of articles should be divided between full time practical work and full time theoretical work. In this country the proportion allocated to full time theoretical work is very small indeed, in the United States of America the opposite is the case. May not "the middle of the road" be the wise and just solution?

The responsibilities of the accountancy profession are ever increasing and the field of activity ever widening. Could there be any matter of more supreme importance than for the profession to make certain that its system of education is absolutely sound and that it is the best that can be provided? Only in that way can the profession make sure that it will render the maximum service to the community. The future must be the responsibility of the rising generation; it is vital, therefore, that future members should be fully equipped in order to shoulder the great responsibilities ahead of them.

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